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Comparative Analysis on Legal Regulation of the Liability of Members of the Management organs of Companies

Law Working Paper N°. 103/2008
February 2008

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We thank Anastasiya Farukshina for comments and research assistance, and Andrew Siegel for translation assistance.

Abstract

This Report was prepared, with support by the World Bank, for the Russian Center for Capital Market Development and the Russian Federal Service on the Securities Market (FSFM). We discuss the liability under company law of members of the board of directors, senior managers, and controlling shareholders of public companies in Canada, France, Germany, Korea, the United Kingdom, and the United States (plus a more limited look at Austria, the European Union, Italy, Japan, and Latvia), and apply this comparative analysis to the Russian context. We recommend amendments to the Russian Law on Joint Stock Companies and related legislation. We propose measures to enhance the effectiveness of derivative suits; define the concepts of good faith and conflict of interest; establish duties of disclosure and confidentiality; extend duties under company law to controlling shareholders and de facto directors for conflict of interest transactions; protect directors against liability for business decisions adopted without a conflict of interest. We do not recommend the creation of significant administrative or criminal liability, nor expanded duties of directors for a company in financial distress. This document includes a separate Overview of the Report by Professor Black which provides an overview of Russia's progress in creating a modern company law.

The Overview and Chapters 1 and 3 were published separately as Legal Liability of Directors and Company Officials Part 1: Substantive Grounds for Liability (Report to the Russian Securities Agency), 2007 COLUMBIA BUSINESS LAW REVIEW 614-799, available at http://ssrn.com/abstract=1010306. Chapters 8-9 and 11-13 will be published separately as Legal Liability of Directors and Company Officials Part 2: Court Procedures, Indemnification and Insurance, and Administrative and Criminal Liability (Report to the Russian Securities Agency), 2008 COLUMBIA BUSINESS LAW REVIEW xxxyyy (forthcoming), available at http://ssrn.com/abstract=1010307. The full Report is available at http://ssrn.com/abstract=1001990 (English version) and http://ssrn.com/abstract=1001991 (Russian version).

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REPORT
to
Russian Center for Capital Market Development
(December 2006)

Comparative Analysis on Legal Regulation of the Liability of Members of the Management Organs of Companies

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Overview of the Report (by Prof. Bernard Black)[1]

Background

This Report was delivered in December 2006 to the Russian securities regulator, known as the Federal Service for the Financial Market (FSFM), and the Russian Center for Capital Market Development, under the longish title *Comparative Analysis on Legal Regulation of the Liability of Members of the Board of Directors and Management Organs of Companies*.[2] The Report provides a detailed comparative analysis of Russia's current law and the laws of several common law or mostly common law countries (Canada, United Kingdom, and United States) and several civil law countries (France, Germany, and Korea), plus a more limited look at the European Union and several additional countries (Austria, Italy, Japan, and Latvia). It then recommends reforms of Russia's company law. The Report was prepared for the *IOS Partners* consultancy in Coral Gables, Florida.

I wrote the sections on the United States, and edited the entire Report. The Linia Prava law firm (Moscow, Russia), especially Alexandra Fasakhova, wrote the sections on Russian law and participated in developing reform recommendations. I was fortunate to recruit an extremely strong group of leading scholars to write the sections discussing other countries. They brought to the task a combination of technical legal knowledge, practical experience in their home countries, and in some cases, prior experience with legal reforms. The contributing experts are Professor Brian Cheffins of the University of Cambridge Law Faculty (Canada and United Kingdom); Dr. Martin Gelter of Vienna University of Economics and Business Administration, Department of Business Law (Austria, France, and Germany); Professor Hwa-Jin Kim of Seoul National University College of Law (Japan and Korea); Mr. Richard Nolan, Senior Lecturer at the University of Cambridge Law Faculty (United Kingdom); and Dr. Mathias Siems, Reader at the University of Edinburgh Faculty of Law and Research Associate at the Centre for Business Research at the University of Cambridge (France, Germany, and Latvia).

I believe that there are no major disagreements among the experts on our reform recommendations. Still, the other experts have asked me to emphasize that the recommendations were prepared by me and Linia Prava. Their responsibility is limited to the specific country analyses which they prepared.

The Russian Law on Joint Stock Companies (below, Russian company law or JSC Law) was adopted in 1995. Reinier Kraakman and I developed the overall conceptual structure

1 This overview represents the personal views of Professor Black, and may not reflect the views of the other authors of the Report. I thank Anastasia Farukshina for her excellent research assistance in completing this Report, and especially in revising the Russian context portion of the original report. I am grateful to Robert Hans and Tea Alania at IOS Partners for the opportunity to participate in this project, and to the Russian lawyers at the Russian Center for Capital Market Development, especially Tatiana Medvedeva and Irina Kadyrova, for extended discussions of their views on the state of Russian company law, carried on in a combination of my imperfect Russian and their imperfect English.

2 Bernard Black, Brian Cheffins, Martin Gelter, Hwa-Jin Kim, Richard Nolan, Mathias Siems and Linia Prava, *Comparative Analysis on Legal Regulation of the Liability of Members of the Board of Directors and Management Organs of Companies* (Dec. 2006), *at* http://ssrn.com/abstract=1001990 (English version) *and* http://ssrn.com/abstract=1001991 (Russian version).

of a "self-enforcing" law, strong on procedural protections against self-dealing, light on substantive prohibitions, and as light as we could make it in reliance on courts. Anna Tarassova and I were the principal drafters of the original 1995 law.[3] That law has since undergone major revisions in 2001 and 2006. I followed those reforms, albeit from a distance. I thus hopefully brought to this project close familiarity with the Russian company law, as well as my own sense of where the law had succeeded and failed. I also brought my strong view that, to be effective, company law must be adapted to local needs, not simply airlifted in from the United States or another developed country.

The immediate purpose of the Report was to recommend further company law reforms to the FSFM. We responded to a series of questions posed by the FSFM, relating to the legal liability of members of the board of directors and other senior company officials. The questions were developed through a highly interactive process. I worked with Russian lawyers at CCMD, Linia Prava, and other law firms and understand the core problems as these counterparts saw them. I then prepared a draft list of issues which the team of experts could address. That list was revised and expanded multiple times, over a period of months.

The process was sometimes painful, as my coauthors can attest. But it was also central to the value of this Report. We needed to define questions that responded to the Russian concerns, yet were framed in a way that permitted comparative analysis. The effort to develop reform recommendations was similarly interactive. Alexandra Fasakhova and I discussed each question, the comparative experience, and potential reforms, and developed specific recommendations for each chapter and subchapter. I drafted, Linia Prava commented, I redrafted, CCMD commented, I redrafted again, and so on.

In every country, corporate governance depends on a complex set of regulations and market institutions, of which company law is only one.[4] Our Report addresses company law, and thus addresses only part of the overall system of Russian corporate governance. In preparing our recommendations, we tried to be sensitive to other Russian laws and institutions which affect corporate governance, and to the status of company law as part

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3 See Bernard Black and Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARVARD LAW REVIEW 1911 (1996), also at http://ssrn.com/abstract=10037). For a detailed section by section overview of Russian company law, see BERNARD BLACK, REINIER KRAAKMAN AND ANNA TARASSOVA, A GUIDE TO THE RUSSIAN LAW ON JOINT STOCK COMPANIES (1998) (Russian version published as Комментарий Федерального Закона об Акционерных Обществах (Издательство Лабиринт (Labirint Press) 1999)) also at (http://ssrn.com/abstract=246670). I cite in this overview a range of my own prior work, with two goals. First, I sought to establish my own claim to knowledge of Russian company law and the Russian environment, and to having thought extensively about the preconditions for effective investor protection, of which company law forms a piece, though only a piece. Second, any set of reform proposals reflects the prior views of the reformer, and thus the reader might want to know where those prior views can be found.

4 I discuss the range of institutions needed to support a robust public market for shares in Bernard Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA LAW REVIEW 781 (2001), *at* http://ssrn.com/abstract=182169. For discussion of the legal rules which predict the strength of public securities markets, see, for example, John Armour, Simon Deakin, Prabirjit Sarkar, Mathias Siems and Ajit Singh, *Shareholder Protection and Stock Market Development: A Test of the Legal Origins Hypothesis* (working paper 2007), *at* http://ssrn.com/abstract=998329; Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, *What Works in Securities Laws?*, 61 JOURNAL OF FINANCE, 1 (2006).

of a broader web of laws and institutions.[5] We also sought to be sensitive to the twin risks of under- and over-regulation. Russian companies need appropriate regulation, to give investors a basis for believing that the company is performing as disclosed, and that their funds will not be stolen by insiders. At the same time, over-regulated securities markets can raise, rather than lower, companies' cost to raise capital.[6] As Russia's history teaches, government powers can be too great as well as too limited.

At this writing, our proposed reforms have not been adopted, and the government has no immediate plans for a legislative proposal. In Russia, as elsewhere, the politics of company law reform are complex. The government is heavily influenced by major companies, who have used the strength of the Russian stock market to argue that there is no urgent need for further reforms.

My personal view is that the Russian Civil Code and the self-enforcing Russian company law, taken as a whole, provides a reasonable basis for protecting minority shareholders against the misdeeds of insiders (company managers and controlling shareholders). Consistent with that view, our Report proposes clarification where the law is unclear and judicial practice is undeveloped or conflicting, expansion of liability in some areas, narrowing in others, but not radical change.

The partial success of the current company law is reflected in Russian share prices. Russia's total market capitalization in mid-2007 was over a trillion dollars.[7] This contrasts sharply to 1999, when $30 billion would have purchased all shares of every public Russian company, had the insiders' stakes been for sale at public trading prices.[8] The 1999 trading prices were often laughable -- for example, $0.026 per barrel of oil reserves and gas equivalents for Gazprom, then and now the world's largest oil and gas company by reserves. Those deeply discounted prices reflected the high risk that most or all value would be captured by controlling shareholders. That risk still exists today, but it has greatly receded. The overall "value ratio" (the ratio of the actual market capitalization of Russian firms to their estimated value at Western multiples) has risen from under 0.01 in 1999 to 0.10-0.20 today. The procedural controls on self-dealing

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5 In a separate phase of the legal advice project, I participated in preparing a draft Russian Law on Insider Trading and Market Manipulation. Such a law, which Russia does not currently have, is another element of an overall corporate governance system.

6 For evidence that the Sarbanes-Oxley Act may have done exactly this, for both U.S. and foreign cross-listed companies, see Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross-Listed in the US*, 13 JOURNAL OF CORPORATE FINANCE 195-228 (2007); Ivy Zhang, *Economic Consequences of the Sarbanes-Oxley Act of 2002*, JOURNAL OF ACCOUNTING AND ECONOMICS (forthcoming 2008), *at* http://ssrn.com/abstract=961964.

7 As of August 31, 2007, the market capitalization of the Russian Trading System (RTS) was U.S $1.053 trillion. *See* http://www.raexpert.ru/ratings/expert400/2007/table2/ (Russian language).

8 See Bernard Black, *The Corporate Governance Behavior and Market Value of Russian Firms*, 2 EMERGING MARKETS REVIEW 89 (2001), nearly final version at http://ssrn.com/abstract=263014.

transactions in the original Russian company law, which are central to our concept of a self-enforcing company law, surely deserve some of the credit.[9]

In some cases, we viewed the Russian company law as superior to a number of the comparison countries. One example involves transactions involving a conflict of interest on the part of directors, members of a company's executive organ, or controlling shareholders. Effective control over these transactions is perhaps the single most important issue addressed by company law, especially in an emerging market. Russia's rules on these transactions are already quite strong. Conflict-of-interest transactions remain a central problem for Russian companies, because conflicts are sometimes not disclosed, and enforcement is weak. The solutions, however, will come primarily in enhanced disclosure, enhanced shareholder suit procedures (the subject of Part 2), and improved courts, rather than from large changes in the company law. When ownership and conflict-of-interest transactions have been concealed, criminal prosecution is required, but this depends more on prosecutorial capacity than on legal rules.

The success of company law is limited by the skill of the courts. Reinier Kraakman and I did our best, to draft a company law that relied on the Russian courts as little as possible. This too was central to our concept of a self-enforcing law. Still, some basic degree of judicial honesty and competence is essential -- perhaps more so than we realized at the time. Unfortunately, and the independence and skill of Russian judges remains in doubt. Judges are sometimes influenced by the views of government officials, and are susceptible to bribes or threats from powerful insiders.

But here too, matters are better than in 1995, when recourse to the courts was widely viewed as an exercise in futility. Jurisdiction over most company law disputes largely rests with the (more expert) "arbitrazh" or commercial courts, rather than the less expert general courts. Judicial decisions addressing the liability of directors and company officials remain limited, but no more so than in a number of the comparison countries. The Russian context portions of this Report include citations to 46 Russian court decisions, a number from the Supreme Arbitrazh Court, the Supreme Court, or the combined Plenum of the Supreme Court and the Supreme Arbitrazh Court. This plenum can express its views on a variety of issues of legal interpretation which have proven troublesome to practicing lawyers or lower courts, even if these issues are not currently before these courts in a particular case. It has exercised this power on a number of occasions.[10]

Russia remains a country whose government has used tax claims and pliable courts to expropriate all shareholder value in one of the country's major companies (Yukos), and harassed both Russian and foreign lawyers who defended Yukos and its controlling

9 On the importance of law in limiting financial tunneling, see Vladimir Atanasov, Bernard Black, Conrad Ciccotello and Stanley Gyoshev, *How Does Law Affect Finance? An Examination of Financial Tunneling in an Emerging Market* (working paper 2007), *at* http://ssrn.com/abstract=902766.

10 See also Kathryn Hendley, Peter Murrell and Randi Ryterman, *Law Works in Russia: The Role of Legal Institutions in the Transactions of Russian Enterprises*, in ASSESSING THE VALUE OF LAW IN TRANSITION ECONOMIES 56 (Peter Murrell editor 2001).

shareholder, Mikhail Khodorkovski.[11] The Putin government has chased other major oligarchs out of the country (Vladimir Gusinski, Boris Berezovski and, most recently, Mikhail Gutsierev),[12] barred a major foreign investor from entering the country because he complained too loudly about insider self-dealing (William Browder of the Hermitage Fund), and so on.[13] A recent *Economist* cover story calls Russia a country run by "spies."[14] Still, the company law is a source of strength, at least if one puts aside the limited occasions when the government subverts it. In many though not all ways, I believe that Andrei Shleifer, a principal Western architect of Russian mass privatization, may be right to call Russia a "normal country."[15] Having a modern company law is among those ways.

Scope of the Report

This Report addresses selected topics related to the duties of the following persons, owed to a joint stock company or, in some cases, to shareholders:

- members of the company's board of directors
- senior company officials; and
- controlling shareholders.

We limit our analysis to publicly traded companies.[16]

The Report contains chapters and, in some cases, subchapters devoted to specific topics. For each, it summarizes the Russian context and offers a comparative analysis covering Canada, France, Germany, Korea, the United Kingdom, and the United States. Where relevant, we also compare the European Union and several other jurisdictions: Austria, Italy, Japan, and Latvia. The comparison countries were chosen to provide a reasonable

11 For a (not very balanced) overview of Khodorkovski's criminal trial, see Otto Luchterhandt, *Legal Nihilism in Action. The Yukos-Khodorkovskii Trial in Moscow*, in UPPSALA YEARBOOK OF EAST EUROPEAN LAW 2005, page 3 (Kaj Hober editor 2005). In reciting the Russian government's actions, I do not mean to defend Khodorkovski. On misdeeds by Khodorkovski and oligarchs, see Bernard Black, Reinier Kraakman and Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STANFORD LAW REVIEW 1731 (2000), also at http://ssrn.com/abstract=181348.

12 Andrew Kramer, *Arrest Ordered for Russian Oil Entrepreneur, a Critic of the Kremlin*, NEW YORK TIMES, Aug. 29, 2007, at C3.

13 On Browder's role in Russian corporate governance, see John McMillan, *Gazprom and Hermitage Capital: Shareholder Activism in Russia* (Stanford Business School Case IB-36, 2002).

14 *Putin's People: The Spies Who Run Russia*, ECONOMIST, Aug. 25, 2007, at 52 (cover story).

15 *See, for example,* Andrei Shleifer and Daniel Triesman, *A Normal Country*, FOREIGN AFFAIRS. 20 (MAR.-APR. 2004); ANDREI SHLEIFER, A NORMAL COUNTRY: RUSSIA AFTER COMMUNISM (2005). The Black-Kraakman-Tarassova work on Russian company law was as part of a USAID funded Russian Legal Reform Project, directed by Professor Shleifer.

16 Chapter 10 of the Report considers which recommendations should also apply to open joint stock companies which are not publicly traded, closed joint stock companies, and limited liability companies. Here too, our reform suggestions were incremental, because Russia has a reasonably modern Law on Limited Liability Companies (adopted 1998), which draws in significant part on the JSC Law. I was an advisor on this Law, but not a principal drafter.

cross-section of world experience, including both common law and civil law countries, with an emphasis on developed countries, but some attention to emerging markets.

This Report is directed at company law reform in the context of Russia, its existing law, and its current needs. Nonetheless, its scope is quite broad. In theoretical ambition, it does not rival the comparative overview by Reinier Kraakman and coauthors.[17] But in scope it does. We know of no comparable resource on the key rules governing director and officer liability across a broad range of common and civil law countries. Our fine-grained review of key topics in company law can complement Kraakman et al., and hopefully advance comparative analysis of company law in both emerging and developed markets.

By making this Report publicly available on the Social Science Research Network (SSRN) website, in both English and Russian, we hope to provide a basis for analysis of legal reform in Russia and other emerging markets. We have studied only the Russian situation and cannot assess which recommendations will be suitable for other countries, but some seem likely to be, perhaps especially for other countries within the former Soviet Union.

A Note on Russian Legal Structure and Terminology

We wrote the English text with a view toward effective translation into Russian, sometimes at the expense of smooth reading in English. Some particularities of Russian law and terminology result in awkward phrasing, and deserve explanation. First, Russia, unlike the U.S., does not have the general concept of a company "officer," who is subject to fiduciary duties due to his position in the company. Instead, duties under company law apply only to members of the board of directors and members of the company's executive organ (which can be a one-person or collegial organ). Following Russian legal terminology, we refer to the board of directors and the executive organ together as the company's "management organs."

A Note on the "Russian Context" Portion of this Report

The original "Russian context" for each chapter was prepared by the Russian law firm of Linia Prava. Different lawyers prepared different sections, under the overall supervision of Alexandra Fasakhova. I substantially shortened the "Russian context" in the Report compared to the original Report as delivered to FSFM, to improve readability for a non-Russian audience. The full version of the Russian context is available on request from Professor Black or Linia Prava.

17 REINIER R. KRAAKMAN, PAUL DAVIES, HENRY HANSMANN, GERARD HERTIG, KLAUS J. HOPT, HIDEKI KANDA AND EDWARD B. ROCK, THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (2004).

Comparative Analysis of Legal Regulation of the Liability of Members of the Board of Directors and Management organs of Companies

Introduction to the Report

Background

This is the Final Report containing a Comparative Analysis on Legal Regulation of the Liability of Members of the Board of Directors and Management organs of Companies, and recommendations for legal reform in the Russian Federation. This Report is being delivered to the Russian Center for Capital Market Development (CCMD) and the Russian Federal Service for Financial Markets, within the Ministry of Finance of the Russian Federation. It was undertaken with assistance from the International Bank for Reconstruction and Development (World Bank).

In every country, effective corporate governance depends on a combination of regulations and market institutions. In accordance with the Terms of Reference for this Report, it addresses primarily reforms to Russian laws, and principally reform to the Law on Joint Stock Companies (JSC Law). Thus, this Report addresses an important part, but only a part of the overall system of Russian corporate governance. In preparing our recommendations, we were sensitive to the risks of either under- or over-regulation. If Russian companies are to receive the full confidence of international investors, appropriate regulation is necessary, especially in the area of conflict-of-interest transactions. At the same time, over-regulated securities markets can make it overly costly for companies to raise capital. As Russia's history teaches, government powers can be too great as well as too limited. The challenge is to find an appropriate balance between the two.

The Consultants are members of a consortium of international and domestic consultants assembled for this Project. The overall Report and recommendations were prepared by the Linia Prava law firm in Moscow, Russia and Professor Bernard S. Black of University of Texas (School of Law and McCombs School of Business) (United States). Individual country reports were prepared by Professor Black (United States); Professor Brian Cheffins of the University of Cambridge Law Faculty (United Kingdom, with expertise on Canada); Dr. Martin Gelter of Vienna University of Economics and Business Administration, Department of Business Law (Austria, with expertise on France and Germany); Professor Hwa-Jin Kim of Seoul National University College of Law (Korea); Mr. Richard Nolan, Senior Lecturer at the University of Cambridge Law Faculty (United Kingdom); and Dr. Mathias Siems (Reader at the University of Edinburgh, School of Law; Research Associate at the Centre for Business Research at the University of Cambridge, with expertise on France, Germany, and Latvia). These experts prepared responses, covering the countries within their expertise, to a detailed list of questions provided by CCMD. Professor Black edited these responses and combined them the overall Report. Linia Prava prepared the discussion of Russian context. Professor Black and Alexandra Fasakhova of Linia Prava served as general editors of this Report and prepared the Summary and Recommendations for each chapter.

The Consultants have undertaken over the past six months extensive research and consultation on the current state of company law and corporate governance in Russia and the comparison countries, Russian experience under the JSC Law, and experience with similar issues in the comparison countries. We have drawn on the expertise of CCMD and Linia Prava on Russian law, and on the international experience of several of the authors of this Report. We also consulted lawyers in private practice in Moscow about their experience with the JSC Law.

Principal Focus of Report

This Report addresses selected topics related to the duties of the following persons, owed to a joint stock company or, in some cases, to shareholders:

- members of the company's board of directors
- members of the company's executive organ (either an individual or a collegial executive organ
- the company's controlling shareholders.

With the exception of Chapter 10, we limit our analysis to a publicly traded open joint stock company. Chapter 10 considers which of our recommendations should also apply to open joint stock companies which are not publicly traded, closed joint stock companies, and limited liability companies.

This report contains chapters and, in some cases, subchapters devoted to specific topics. For each chapter and subchapter, we provide a summary of the Russian context, a comparative analysis covering Canada, France, Germany, Korea, the United Kingdom, and the United States. Where relevant, we also provide a comparison to several other jurisdictions: Austria, Italy, Japan, and Latvia, and to the European Union. The comparison countries were chosen to provide a reasonable cross-section of world experience, including both common law and civil law countries, with an emphasis on developed countries, but also some attention to emerging markets.

This report includes a list of laws and abbreviations indicates the principal laws that are discussed in this Report. Where English language versions of these laws are available on the internet, this is indicated. Particular provisions of the laws of particular countries are sometimes quoted in the body of this Report. This report also often cites books, articles, and legal cases. Particular passages are sometimes quoted in the body of this Report. However, direct quotations are limited to keep this Report to a manageable length.

For some of the recommendations provided below, we have been advised that the proposed reforms may not be feasible in Russia at the present time. We consider it better to offer our best advice, understanding that this advice will not be fully implemented, than to avoid providing advice that we believe is sound, even though it is likely not to be implemented in the near future.

Some of the recommendations we offer may be relevant to other countries within the former Soviet Union, or perhaps to other emerging markets. However, we have studied only the Russian situation and cannot assess which of the recommendations might be suitable for other countries.

General Assessment of Current Russian Law

We offer a number of specific recommendations below for improvements in Russian law concerning the duties of directors, members of a company's executive organ, and controlling shareholders owed to their companies and, occasionally, directly to shareholders. At the same time, it should be recognized that these recommendations are incremental in nature. Russia benefits from a recently adopted Civil Code that is comparable to other modern civil codes. Russia also benefits from recently adopted laws on joint stock companies and limited liability companies that draw on experience in other countries and were also drafted with the specific Russian situation in mind.

The Law on Joint Stock Companies was adopted in 1995 and has been subject to major amendments in 2001 and in 2006. The Law on Limited Liability Companies was adopted in 1998. It has not been significantly amended, but this may be appropriate, because it is a simpler law than the Law on Joint Stock Companies. In some important respects, these laws already address the issues discussed in this Report. In some cases, the Russian treatment is superior to that in a number of comparison countries.

One noteworthy example involves the rules governing transactions involving a conflict of interest on the part of directors, members of a company's executive organ, or controlling shareholders. Effective control over these transactions, to limit the number of these transactions and to ensure that any such transactions are on terms that are fair to the company and thus to minority shareholders, is perhaps the single most important issue to be addressed by the Law on Joint Stock Companies. Russia already has quite strong laws addressing this issue, including Chapter 11 of the Law on Joint Stock Companies. Disclosure of conflicts of interests is sometimes not made, and enforcement is often weak. As a result, conflict-of-interest transactions remain a central problem for Russian companies. The solutions, however, will come primarily in enhanced disclosure and enhanced opportunities for shareholder suits, rather than from large changes in the law.

Thus, for example, an effective system for disclosure of ownership by directors, members of a company's executive organ, controlling shareholders, and their affiliated persons, could be highly important in ensuring effective control of conflict-of-interest transactions. Yet ownership disclosure rules are outside the scope of this Report. An effective procedure for shareholders to bring lawsuits is also extremely important in controlling conflict-of-interest transactions. The procedures for shareholder suits are discussed in this Report, but much of the needed reforms lie beyond the scope of this Report, and involve the general quality of the judiciary and general rules of civil procedure. When ownership and conflict-of-interest transactions have been concealed, effective criminal prosecution is required, but this depends on prosecutorial capacity rather than on legal rules.

More generally, effective protection of minority shareholders depends on a complex, interrelated set of laws and institutions.[1] This report addresses only a limited subset of these laws and institutions. The laws and institutions it addresses can be improved, but on the whole, they are reasonably designed and hence need only incremental reform. The

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1 See Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA LAW REVIEW 781-855 (2001), also at http://ssrn.com/abstract=182169.

most critical weaknesses of Russian securities markets lie outside the scope of this Report.

Summary of Recommendations

The table below summarizes the recommendations we make in the body of this Report, and the laws that are affected by these recommendations. This summary is phrased to apply to members of the board of directors. The recommendations also apply to the company's individual executive organ or the members of the collegial executive organ (we refer to both below as "members of the executive organ"). Recommendations that relate to transactions involving a conflict of interest also apply, in general, to controlling shareholders.

Summary of Recommendations

This summary discusses our principal recommendations for members of the board of directors of an open joint stock company whose shares are publicly traded. For more detailed recommendations, please see the individual chapters of this Report. Chapter 10 discusses which recommendations should also apply to other types of companies. In general: (i) recommendations for directors also apply to the members of the executive organ, to an external manager or managing organization, and to the directors and members of the executive organ of a managing organization who adopt decisions on behalf of the company; (ii) recommendations for transactions involving a conflict of interest also apply to controlling shareholders; and (iii) references to transactions by a company include transactions by a subsidiary or dependent company. Some recommendations are discussed in more than one chapter of this Report. These recommendations are indicated below only once.

Chapter	**Recommendations**
1.1 Overview of each country	None
1.2 Concept of reasonableness and good faith	No need to amend Civil Code art. 53 Changes to the JSC Law are recommended: ➢ to specifically state that the obligation of directors to act reasonably includes the obligation to become reasonably informed before adopting a decision ➢ to adopt a form of the business judgment rule, to protect directors against liability for adopting decisions that do not involve a conflict of interest ➢ to specify the core elements of the duty of good faith ➢ to establish a duty of disclosure for directors, including the obligation to disclose any conflicts of interest ➢ to extend the duty of good faith to a controlling shareholder, for transactions by the company involving a conflict of interest.
1.3 Should there be a presumption of reasonableness and good faith	Changes to the JSC Law are recommended: ➢ to adopt a presumption of reasonableness, if the directors act based on reasonable information and without a conflict of interest ➢ this presumption of reasonableness can be embodied in a form of the business judgment rule ➢ to specify that there is no presumption of reasonableness, for a transaction which involves or may involve a conflict of interest may exist ➢ to specify that there is a presumption of lack of good faith, for a transaction which involves a conflict of interest

Chapter	Recommendations
1.4 Concept of self-interest	Changes to the JSC Law are recommended: ➢ to define the concept of a conflict of interest for purposes of fault-based liability under art. 71 of JSC Law ➢ to specify that a conflict of interest can be direct or indirect For improved functioning of the board of directors, changes to the JSC Law are recommended: ➢ to permit companies to provide in their charters for delayed review by the board of directors of de minimis transactions which may involve a conflict of interest ➢ to permit the members of the board of directors to unanimously waive the requirements for advance notice of meetings of the board of directors
1.5 Transactions with controlling shareholder.	Changes to the JSC Law are recommended: ➢ to require controlling shareholder to provide material information to the company about a transaction for which the controlling shareholder has a conflict of interest; ➢ to specify that it is a violation of the duty of good faith for a controlling shareholder to put pressure on the company's directors to approve a transaction for which the controlling shareholder has a conflict of interest ➢ to specify that directors who approve a transaction in which the controlling shareholder has a conflict of interest, including non-interested directors, have the burden of proving that they were informed, and made a reasonable decision,
1.6. Additional bases for civil liability	Bases of liability other than under the JSC Law are generally beyond the scope of this Report. Changes to the JSC Law are recommended, in addition to the changes discussed above: ➢ to add a duty of confidentiality of company directors for a company's nonpublic business information ➢ to require the company's executive organ to provide information to the board of directors ➢ to provide that it is a violation of the duty of good faith to knowingly provide incomplete or misleading information to the board of directors Changes to the Law on Capital Markets are recommended: ➢ to require all directors, including non-executive directors, to review a company's prospectus for a public offering and satisfy themselves that the prospectus is reasonably accurate and complete, with liability for gross negligence if they do not comply with this obligation
1.7. Remedies for breach of duty	The measure of damages (ubuoytki) specified in the JSC Law art. 71 and Civil Code art. 15 is sufficient. No changes are recommended. Changes are recommended to the JSC Law: ➢ to specify that the remedy of invalidation of the transaction, in JSC Law arts. 79, 84 should be applied only if invalidation will not cause harm to third parties

Chapter	Recommendations
2. Legal nature of relationship between a director and a company.	This relationship is primarily contractual in nature. Changes to the JSC Law are recommended: ➢ to specify that, with limited exceptions, only a general shareholder meeting can dismiss a director from his position on the board of directors to specify that a director may voluntarily resign from his position before the end of his term ➢ to specify that if a director dies or resigns before the end of his term, a replacement director may be elected by a general shareholder meeting, without reelecting an entire new board
3. Different liability rules for different members of management organs	The same duties and the same standards of liability should generally apply to all directors, with the following nuances: ➢ Distinctions between different types of directors, for example non-executive chairman versus other non-executive directors, new director v. long-serving director, member of specific committees, etc. do not need to be stated in the law; and can be left to the courts to determine ➢ If litigation against non-executive directors, based on breach of the duty of reasonableness, becomes a significant risk, it may be appropriate to establish a different standard of liability for non-executive directors, or to limit their monetary liability for decisions that do not involve a conflict of interest Changes to the JSC Law are recommended: ➢ to excuse a government-appointed director from compliance with the duty of reasonableness and the duty to act in the company's interests for adopting a decision, without a conflict of interest, in accordance with written instructions from the director's superiors in the government
4. Application of labor code to company executives	Changes are recommended to the JSC Law: ➢ to clarify that an executive director who is dismissed as a manager by the board of directors retains his position on the board of directors ➢ to provide that a director who is dismissed early by decision of a general shareholder meeting should receive compensation for the remainder of his term, unless the dismissal is for good cause

Chapter	Recommendations
5. Liability of managing organization (individual manager) and employees of managing organization	Changes are recommended to the JSC Law: ➢ to clarify that an individual manager, or a managing organization, has the same duties as a member of the board of directors; ➢ to specify that a managing organization should be liable in any circumstance in which the persons within the managing organization who adopt decisions on behalf of the managed company would be liable if they directly managed the company; ➢ to specify that the persons within a managing organization, who adopt decisions on behalf of a company, have the same duties to the managed company as if this person were a director of the managed company ➢ to specify that if a managing organization is found liable for breach of duty to the managed company and has insufficient assets to pay a judgment, the persons within the managing organization who adopt decisions on behalf of the company should be secondarily liable ➢ to adopt the concept of a *de facto* director, who acts as if he had an official position with the company, and should have the same duties to the company as an official director.
6. Liability in the case of bankruptcy	We do not recommend additional liability for directors of an insolvent company, beyond the liability which already exists in the JSC Law and the Bankruptcy Law; We do not recommend liability of directors for not causing the firm to file for insolvency proceedings as it approaches bankruptcy.
7. Liability for actions involving subsidiary and dependent companies	Protection of creditors of subsidiaries should be addressed in the Bankruptcy Law, which is beyond the scope of this Report. Changes are recommended to the JSC Law: ➢ to specify that when a parent company, or its managers, in fact manages a subsidiary (or dependent company), the company and the persons who manage the subsidiary should face the same liability as a managing organization and the persons within a managing organization who adopt decisions on behalf of a managed company

Chapter	Recommendations
8.1 Procedural aspects of directors' liability	Changes are recommended to the JSC Law, the Arbitrazh Procedure Code, and the interpretive rules of the Supreme Arbitrazh Court: ➢ to specify that disputes involving joint stock companies and their shareholders should be heard exclusively by the arbitrazh courts ➢ to provide the same procedures for a shareholder suit for breach of duty and for completion of a self-interested transaction ➢ to provide similar procedures for other instances in which a shareholder can bring an action under the JSC Law, including actions to invalidate a decision of a general shareholder meeting or a decision of the board of directors ➢ to specify that if a shareholder brings a successful derivative suit, the company should pay the shareholders' expenses to bring the suit, incurred in accordance with ordinary business practices, to the extent these expenses are not paid by the losing party; ➢ to specify that if a derivative suit is unsuccessful, the shareholder should pay the defendants' legal costs only if the court finds that the was an abuse of rights by the plaintiff in bringing the suit; ➢ to specify that a derivative suit is brought by a shareholder, with the company as a third party beneficiary ➢ to provide the trial judge with discretion on what role the company should play in a derivative suit
8.2 Abuses in suits by shareholders	Changes are recommended to the JSC Law and the Arbitrazh Procedure Code: ➢ to require notice to all shareholders, an opportunity to participate in a derivative suit or to elect not to be bound by the outcome of the suit; ➢ to require disclosure of conflicts by the plaintiff-shareholder; ➢ to specify that it is a breach of duty for a company's directors to procure an improper settlement or dismissal of a suit, on terms which do not protect the company's interests; ➢ to require shareholder approval of a settlement of a derivative suit; ➢ to require judicial review of an agreement to settle a derivative suit.
8.3 Powers of regulator in civil actions	We consider the question, whether the FSFM should have the power to bring a civil action to enforce the duties of directors and controlling shareholders of public companies under company law, to be a close one. We have no recommendations either in favor of or against this power.

Chapter	Recommendations
9.1 Compensation by company for damages and expenses	Changes are recommended to the JSC Law [and other appropriate laws] *Compensation for damages* ➢ to specify that a company may agree in advance, by contract or through a provision in the charter or bylaws, to compensate directors for amounts paid to third parties arising out of their official duties on behalf of the company, for actions not involving a conflict of interest or personal benefit, provided that the compensation is approved by non-interested shareholders and a court finds that the director has acted in good faith and in the interests of the company; *Compensation for legal and other expenses* ➢ to specify that a company may agree in advance, by contract or through a provision in the charter or bylaws, to compensate directors for legal and other expenses for civil suits and administrative and criminal proceedings relating to their actions with respect to the company, provided that the compensation is or advancement of expenses is approved by non-interested shareholders, and that the director must repay any advanced expenses if a court finds that the director did not acted in good faith and in the interests of the company; ➢ to specify that a company may advance expenses, without regard to a director's ability to repay; ➢ to specify that a company shall compensate directors for legal and other expenses if the director is successful in defending against a civil suit or other proceeding
9.2 Insurance against directors' liability	Changes are recommended to the JSC Law and the Civil Code: ➢ to permit a company to purchase directors' and officers' liability insurance for its directors, provided that the amount, principal terms, and cost of the insurance are disclosed to shareholders and approved by non-interested shareholders at a general shareholder meeting. ➢ to specify that D&O insurance should be permitted to cover legal and other expenses in all cases, including administrative and criminal proceedings; The specific terms and amounts of D&O insurance do not need to be specified in the law.
10. Application to nonpublic open companies, closed companies, limited liability companies	Changes are recommended to the Law on Limited Liability Companies: ➢ selected recommendations concerning the duties of directors and controlling shareholders generally should also apply to all types of companies, including limited liability companies and closed joint stock companies ➢ recommendations concerning the power of the FSFM apply only to public companies ➢ some recommendations for public companies can be adopted in simpler form for limited liability companies ➢ some recommendations for public companies should be default rules for other companies
11. Practical experience in other countries.	There are no recommendations in this chapter.

Chapter	Recommendations
12.1 Administrative offences	We do not recommend that the FSFM should have the power to obtain administrative fines or penalties, either directly or through court proceedings.
12.2 Procedural aspects of administrative liability	Change is recommended to the JSC Law and the Administrative Procedure Code: ➢ to provide that the FSFM should have the power to investigate breach of duty by directors of public companies ➢ to give the FSFM the power to bar directors of public companies from serving as a director or a member of the executive organ of a public company, based on a serious breach of duty;
13.1 Criminal offenses	We do not recommend that the a breach of duty to the company under company law should give rise to criminal liability. Existing criminal law addresses theft and other serious misuse of company positions for personal advantage.
13.2 Procedural aspects of criminal liability	We do not recommend that the FSFM have the power to bring a criminal prosecution. We do not recommend special procedural rules to govern any criminal liability for breach of company law

Chapter 1: Conditions of civil liability of directors, members of a company's management organs, and controlling shareholders: key problems.

Subchapter 1.1 General context for each country

We consider in this Report laws of general applicability that apply to all joint stock companies ("companies"), or to all public companies. We do not consider laws applicable to specific industries, such as banking or insurance. A number of countries, including Korea and the United States, have specific governance rules that apply to companies in the financial sector. Except in Chapter 10, we do not discuss limited liability companies.

Russia

The primary provisions concerning the civil liability of the members of a company's management organs (the board of directors and the executive organ) can be found in the Civil Code and the JSC Law. The Civil Code norms apply only to the company's executive organ and its members. The JSC Law extends these norms to the board of directors and its members. We will refer to the executive organ, the board of directors, and their members together as "governing entities." Unless otherwise specified, all references to laws and judicial decisions in the Russian Context portions of this Report are to laws and courts of the Russian Federation.

Civil Code art. 53(3) and JSC Law art. 71(1) establish that a company's governing entities must act (a) *in the interest of the company* and (b) *reasonably and in good faith*. These organs are liable to the company for any losses the company incurs as a result of their wrongful actions or nonfeasance. The JSC Law does not contain a list of specific actions which are considered to be wrongful. Instead, the law establishes only a general rule on the bases for civil liability.

The elements of civil liability are:

1) a company incurs losses as a result of the wrongful action (inaction) of the governing organ;

2) a causal relationship between the governing organ's conduct and the company's losses; and

3) the existence of culpable conduct.

Under Civil Code art. 401(1), a person is considered culpable if he fails to exercise the proper degree of *care and discretion* in fulfilling its obligations. As these two concepts are not defined in Russian law or judicial practice, the measure of culpability is interpreted through the concept of *good faith*.

A person's wrongful conduct (violation of the obligation to act reasonably, in good faith, and in the interests of the company), and the measure of culpability (lack of good faith) are separate criteria in determining liability, each of which should be established independently. For example, the burden of proving wrongful conduct lies with the plaintiff (e.g., the shareholder), but if the plaintiff can show wrongful conduct, the defendant has the burden of establishing the absence of culpability (Civil Code art. 401(2)).[2]

The liability rules established by the Civil Code and the JSC Law apply uniformly to all governing entities, including a managing organization and both executive and independent directors. However, it remains unclear whether they apply to (i) *former* governing entities, for losses to the company incurred through their wrongful acts while in office, (ii) a *temporary* collegial executive organ or its members, or (iii) a liquidation committee or its members. The liability rules apply only to persons who are members of a company's management organs, and thus apply to members of a company's senior management only if these persons are members of the board of directors or the executive organ. Otherwise, the liability of these persons to the company is specified by labor law.

The JSC Law exempts the members of a management organ from liability if they voted against a decision resulting in losses to the company or did not participate in voting. JSC Law art. 71(4) establishes the joint and several liability of members of a collegial organ who are found liable (Civil Code art. 323 discusses the recovery procedures in this case). JSC Law art. 71(5) provides that a company -- as well as shareholders holding in aggregate at least 1% of the company's outstanding common shares have the right to file a suit against a governing entity (a derivative suit).[3]

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2 For further details on the elements of liability, see Chapter 2.

3 We discuss derivative suits in subchapter 8.1.

Austria

Austria is a civil law country. Austrian law is strongly influenced by German law. In particular, the Austrian law on joint stock companies (*Aktiengesetz,* or *AktG*) is based on the German AktG. Section numbers are different but the substance and language is usually similar. The Austrian law on limited liability companies (Austrian GmbH Gesetz) is also similar to its German counterpart, although to a lesser degree than the joint stock company law. German court decisions are often considered persuasive authority in Austrian corporate law, so case law is similar in the two countries as well.

In this Report, we discuss Austrian law to a limited extent, only where it is different from German law.

Canada

Canada is a common law country. Its legal rules have been strongly influenced by the United Kingdom and by the United States.

Canada has a "federal" legal system, in which each province has authority to determine laws within its legislative competence, as specified in the Canadian constitution. There is a federal corporation law, the Canadian Business Corporation Act (CBCA), but this law is optional, rather than mandatory.[4] Each province also has its own corporation law, and firms can choose to be governed by one of these laws instead. However, the corporation laws of most provinces are similar to the CBCA. To simplify the analysis, this Report focuses on the CBCA and on the Ontario Business Corporations Act (OBCA).[5] The OBCA is deserving of special attention because Ontario is Canada's most heavily populated province, is the home of Canada's financial center (Toronto), and has larger and more active capital markets than other provinces.

Because Canada is a common law country, judicial decisions are an important source of authority, in addition to the formal company law.

Canada does not have a separate law for nonpublic companies, which would be similar to the limited liability company under Russian law.

European Union (EU)

European Union level company law consists of regulations (which apply directly to companies), directives (which must be implemented through legislation or regulation by each Member State), and recommendations (which are non-binding). For the most part, EU regulations, directives, and recommendations do not directly address issues related to the liability of directors and managers. We discuss EU authority of all three types of legislation briefly in the body of this Report.

At the level of the European Community, there is no voluntary Code of Corporate Governance similar to the codes found in individual countries such as Germany and the

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4 The CBCA is at http://www.canlii.org/ca/sta/c-44/.

5 The OBCA is at http://www.canlii.org/on/laws/sta/b-16/20060718/whole.html.

United Kingdom. However, the use of such codes is advocated in a 2005 Commission Recommendation, which also addresses the role of non-executive or supervisory directors of listed companies.[6]

Beginning in late 2004, European Union law provides for the possibility that a company can be formed as a European Company (SE). European companies can choose either a one-tier board structure, or a two-tier structure similar to that in Germany. The law on SE companies does not specify the duties of directors. Instead, these are determined by the law of the member state which is the company's principal location.[7] The European company form is gradually becoming more popular, but there are as yet extremely few judicial decisions interpreting the SE law.[8]

France

The law on French joint-stock companies (*sociétés anonymes*) is largely contained in the French Commercial Code (*Code de Commerce* 2000, as amended, in particular arts. L. 224-1 through 248-1).[9] Some questions concerning interpretation of the Commercial Code are also addressed in a governmental decree (Décret no 67-236 sur les sociétés commerciales, as amended).

French law allows joint stock companies to choose either a one-tier or a two-tier board structure. Overall, about 97% of joint stock companies employ a one-tier board, and only 3% employ a two-tier form. However, the two-tier board is more popular among very large companies. Among the 40 major companies included in the CAC 40 stock index, 80% choose a one-tier board and 20% choose a two tier board.[10]

In this Report, we discuss separately the rules that apply to firms with a one-tier board, that includes both company executives and non-executive (or "outside") directors, and a two-tier board, similar to the German model. In the two-tier system, the upper, or supervisory, board contains only outside directors and is elected by shareholders, and the lower, or management, tier contains company executives, who are appointed by the supervisory board.

The French two-tier board is adapted from Germany. For a company with a two-tier board, the division of powers between the supervisory board and the management board is similar to the division of powers in a German company. The main provision on the powers of the supervisory board is Code de Commerce, art. L. 225-68, under which:

6 *See* 2005/162/EC, *at* http://eur-lex.europa.eu/LexUriServ/site/en/oj/2005/l_052/l_05220050225en00510063.pdf.

7 See Council Regulation (EC) No. 2157/2001 (Oct. 8, 2001) on the Statute for a European company, especially arts. 38(b), 51.

8 For an overview of the SE form and a list of SE companies, see http://www.seeurope-network.org/homepages/seeurope/secompanies.html.

9 An English version of the Code de Commerce, although not the most recent version, can be found at http://195.83.177.9/code/liste.phtml?lang=ukandc=32.

10 Michel Storck, *Corporate Governance a la Française – Current Trends*, 1 EUROPEAN COMPANY AND FINANCIAL. LAW REVIEW 36, at page 37 (2004).

- The supervisory board appoints and exercises permanent monitoring of the executive board's management of the company.
- The supervisory board must approve the sale of real property, the sale of shares, the obtaining of loans, guarantees, and similar financial undertakings from companies other than banks or other financial institutions.
- The supervisory board carries out the verifications and inspections which it considers appropriate at any time and may request whatever documents it considers appropriate for that task.
- The executive board submits a report to the supervisory board at least once each quarter.
- The executive board submits the company's annual financial and other reports to the supervisory board. The supervisory board presents its observations on the executive board's report and the financial accounts at the annual general shareholder meeting

The main provisions on the powers of the management board are:

> Code de Commerce art. L. 225-64: The management shall have the widest powers to act on the company's behalf in any circumstances. It shall exercise its said powers within the limits of the purpose of the company and subject to the powers expressly attributed by the law to the supervisory board and shareholders' meetings.
>
> Code de Commerce art. L. 225-66: The chairman of the management or the sole managing director, as the case may be, shall represent the company in its dealings with third parties.

The principal decisions adopted by a general shareholder meeting are:

- amending the charter (Code de Commerce art. L. 225-96);
- mergers and divisions (Code de Commerce art. L. 236-9)
- changes in share capital (Code de Commerce arts. L. 225-129, 225-204);
- sale of the company's whole assets (Code de Commerce art. L. 237-8(no.4));
- approving annual accounts and distribution of profits (Code de Commerce arts. L. 232-11, 232-12);
- electing directors (Code de Commerce arts. L. 225-18, 225-75); and
- approving directors' substantial self-dealing transactions (Code de Commerce arts. L. 225-38 through 40).

French law provides for both a simplified joint stock company form (*SAS*) that is intended for use by non-public companies, and a limited liability company form (*SARL*).

France has adopted a voluntary Corporate Governance Code for public companies.[11]

Germany

Germany is a civil law country. The Russian Civil Code is often considered to have been substantially influenced by the German Civil Code. Germany has a federal legal system, but there is a single national law on joint-stock companies, the *Aktiengesetz* (*AktG*). The current version of the AktG was enacted in 1965 but it has been amended frequently, including most recently in the UMAG act of 2005, which expanded the possibility for shareholders to bring derivative suits, and also added a statutory business rule defense to liability.

The AktG requires firms to have a two-tier board structure, with a supervisory board and a management board. The supervisory board is composed entirely of non-executives, and is elected by shareholders. The powers of the supervisory board include the right to appoint the members of the management board (AktG § 84), to supervise management (AktG § 111 I), and to represent the company in dealings with members of the management board.[12]

In principle, once the supervisory board has appointed the members of the management board, usually for a several-year term, it does not have the right to dismiss them, absent good cause (AktG § 84(3)). In practice, if the supervisory board loses confidence in the CEO, the CEO is likely to resign.

The management board is analogous to the collegial executive organ in Russia. Its members are chosen by the supervisory board. The AktG does not prescribe a particular structure for the management board, but it will be common for a public company to have

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11 Principes de gouvernement d'entreprise résultant de la consolidation des rapports conjoints de l'AFEP et du MEDEF.

12 *See* KARSTEN SCHMIDT, GESELLSCHAFTSRECHT 820 (4th edition 2002). Additional powers of the supervisory board include:

- reviewing the procedure for forming the company (AktG § 33 I AktG);
- convening a special shareholder meeting (AktG § 111 III);
- approving management decisions, if the charter or a decision of the supervisory board requires this approval (AktG § 111 IV). The supervisory board may not adopt management decisions itself. If it objects to a decision of the management board for which its approval is required, the decision can be approved by the shareholders with a 75% supermajority vote);
- approving loans to members of the management board, the supervisory board, certain officers of the company and their family members (AktG §§ 89, 115);
- approving contracts with members of the supervisory board (AktG § 114);
- preparing proposals for shareholder votes (AktG § 124 III);
- concluding the contract with the external auditor (AktG § 111 II);
- examining the annual accounts, management report, consolidated accounts, and the dividend proposal (AktG § 171), and approving the annual accounts (AktG § 172); and
- creating reserves (AktG § 58 II).

a CEO, who will be a member of the management board, and often will be the chair of the management board.

The management board's principal duty is to manage the company (AktG § 76 I AktG) and to represent the company in dealings with third parties (AktG § 78 I) and with the members of the supervisory board. Decisions that do not require approval by the supervisory board or by shareholders (including amendments to the charter, mergers, and the issuance of shares) can be adopted by the management board on its own. However, as a practical matter, the management board will often inform the supervisory board and obtain its consent for major proposed decisions, even when this is not formally required.

Although the two boards have different powers, their formal duty of care owed to the company, for actions within their competence, is the same.[13] The duty of good faith, derived from court decisions, is also presumably the same for both boards. Therefore, our discussion of directors' duties will generally not distinguish between the two boards.

German labor law requires "codetermination" of the members of the supervisory board of larger public companies, with 1/2 of the members chosen by labor unions (MitbestG, or Co-determination Act 1976). Shareholder-elected members still have a dominant voice because the shareholders elect the chairman of the supervisory board, and the chairman can cast a deciding vote if there is otherwise an even split among the board members.

Commentators have speculated that codetermination is one reason why the German supervisory board has limited powers, compared to the unitary boards of directors in other countries. The logic is that the shareholders do not want to share power or information with labor representatives.[14] The expansion of codetermination in 1976 induced many companies to reduce the powers of the supervisory board specified in the charter.[15] However, other authors have suggested that codetermination may improve the flow of information to the supervisory board.[16] The empirical evidence on the effects of codetermination is inconclusive. One study suggested that codetermined firms trade at a discount in stock markets,[17] but others have found that codetermination is associated with increased productivity or improved governance.[18]

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13 The duty of care for management directors is specified in AktG § 93. The principal duties of supervisory directors are specified in AktG § 116. However, AktG § 116 simply provides that supervisory directors have the duties specified in AktG § 93.

14 Mark J. Roe, *German Codetermination and German Securities Markets,* 1998 COLUMBIA. BUSINESS LAW REVIEW 167; Jean J. Du Plessis and Otto Sandrock, *The Rise and Fall of Supervisory Codetermination in Germany,* 16 INTERNATIONAL COMPANY AND COMMERCIAL LAW REVIEW 67 (2005), at 74-75.

15 Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities, in* EMPLOYEES AND CORPORATE GOVERNANCE 163 (Margaret M. Blair and Mark J. Roe editors, 1999).

16 Gérard Hertig, *Codetermination as a (Partial) Substitute for Mandatory Disclosure,* 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 123 (2006).

17 Gary Gorton and Frank A. Schmid, *Capital, Labor and the Firm: A Study of German Codetermination,* 2 JOURNAL OF THE EUROPEAN ECONOMIC ASSOCIATION 863 (2004).

18 Felix FitzRoy and Kornelius Kraft, *Co-determination, Efficiency and Productivity,* 43 BRITISH. JOURNAL OF INDUSTRIAL RELATIONS 233 (2005); Larry Fauver and Michael E. Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence from German Boards,* 82 JOURNAL OF FINANCIAL ECONOMICS 673 (2006).

The principal decisions adopted by a general shareholder meeting are (AktG § 119 I):[19]

- electing supervisory board members (except for employee representatives and members appointed by specific shareholders under the charter);
- utilizing profits (for example, to pay dividends);
- exoneration of board members;
- appointment of the auditor, including appointment of a special auditor;
- amending the charter (including transformations and mergers);
- increase and reduction in share capital;
- dissolution of the company; and
- in addition, a separate law governing mergers and divisions (UmwG) generally requires shareholder approval of these actions.

The Russian law on joint stock companies is often considered to have been significantly influenced by U.S. corporation law and by the German law on joint stock companies.

Germany has a voluntary Code of Corporate Governance, which applies to public companies. Public companies are required to inform shareholders annually of the extent to which they comply with this code (AktG § 161).

Germany has limited liability companies and a related limited liability company law (GmbH Gesetz). The Russian law on limited liability companies is often considered to have been significantly influenced by the German law.

Italy

Italy is a civil law country. It is strongly influenced by French and German law. We consider Italy only briefly, when it differs in interesting ways from France and Germany. The Italian law on joint-stock companies (*Società per Azioni),* as well as the law on limited liability companies *(Società a responsabilità limitata)* are included in the Italian Civil Code (*Codice civile*).

Similar to France, Italian companies can choose between a two-tier and a one-tier board structure. Italy further complicates matters by providing for two types of one-tier boards.[20]

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19 On the powers of shareholders in European companies, compared to U.S. companies, see Mathias Siems, *Shareholder Protection Across Countries - Is the EU on the Right Track?*, 4/3 JOURNAL FOR INSTITUTIONAL COMPARISONS 39 (2006), *at* http://www.cesifo-group.de/DocCIDL/dicereport306-rr1.pdf.

20 This is the result of a recent reform. *See* Marco Ventoruzzo, *Experiments in Comparative Corporate Law: The Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absence of Effective Regulatory Competition*, 40 TEXAS INTERNATIONAL LAW JOURNAL 113 (2004).

Korea

Korea is a civil law country. It has been influenced especially by Japan and Germany. Korean corporate law is part of the Korean Commercial Code (KCC). The KCC has also been influenced by statutes, cases, and scholarly works from Continental Europe and the United States.[21]

Until 1962, Korea relied on Japanese corporate law, which was a chapter of the Japanese Commercial Code (JCC). Japanese corporate law, in turn, was promulgated in 1899 based on the German law on joint stock companies at that time. However, Japanese corporate law was thoroughly revised after the Second World War, and was heavily influenced at that time by the United States, especially the Illinois Business Corporation Act of 1933.

However, since the East Asian financial crisis of 1997-1998, Korean corporate law has undergone significant changes, with strong influence from the United States. The KCC has been significantly revised in 1984, 1995, 1998, 1999 and 2001, and another general revision is in progress, with completion expected in 2007. Revisions to the KCC are supervised by the Ministry of Justice.

A second and, for public companies, more important source of Korean corporate law is the Korean Securities and Exchange Act (KSEA), changes to which are supervised by the Korean Ministry of Finance and Economy. The KSEA was promulgated in 1962 and has been revised numerous times especially after 1997. The KSEA is different from securities laws in most other countries in that it heavily regulates the corporate governance of public companies.

A stock company in Korea can exist as a private company or as a public company such as a "Korea Exchange-listed company" or "KOSDAQ-listed company." Nonpublic companies are governed by the KCC but not by the KSEA. Public companies are also subject to the KSEA. Korea currently is consolidating seven laws related to the capital markets, including the KSEA, into one law. However, the substance of the corporate governance provisions of the KSEA is expected to be retained in the new consolidated law.

In 1999, the Korean Committee on Corporate Governance adopted a Code of Best Practice for Corporate Governance, which was revised in 2003. The code is similar in concept to the Russian Corporate Governance Code, in that it is solely an informal guideline for the corporate governance of public companies. In contrast to the United Kingdom, companies have no obligation to either comply with the code or explain to shareholders why they have not done so. However, the Korean government is planning to add a “comply with the Code or explain why not” obligation to either the KSEA or the listing rules of the Korea Stock Exchange.

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21 An English translation of the Companies portion of the KCC can be obtained at http://www.moleg.go.kr/english (follow Economic Laws hyperlink to get a list of laws; then go to page five of the list and follow Commercial Act hyperlink).

Latvia

Latvia is a civil law country. Its legal system is strongly influenced by Germany. The Latvian Commercial Code[22] contains separate chapters which govern joint-stock companies and limited liability companies, although there are also some common provisions that govern both types of companies. The chapter on joint stock companies follows the German model of a two-tier board structure.

United Kingdom

The United Kingdom of Great Britain (that is, England, Scotland, Wales, and Northern Ireland) is a common law country. U.K. corporate law is contained primarily in the Companies Act 1985, as amended, but is extensively supplemented by common law decisions. The Companies Act 1985 is a consolidation of earlier laws going back more than a century. It is supplemented by other statutes and codes, to which we will refer as relevant.

This Report was prepared at a time when the British legislature was in the late stages of considering a major revision to the Companies Act. The new Companies Act 2006 was adopted in late 2006, after this Report was substantially completed. It will be fully effective in the fall of 2008. We will discuss primarily the Companies Act 1985, but will refer when relevant to the provisions of the Companies Act 2006.

Australia, Canada, New Zealand, and the United Kingdom are all part of the British Commonwealth and share a similar common law legal heritage. Within each country, the decisions of its own courts will have the most direct value as persuasive "precedent," which a court is likely to follow. However, especially if there are no closely relevant cases in one of these countries, the courts of each will often look to decisions by the courts of the other countries in a search for persuasive precedent. Perhaps because of its size and because it has been independent of the United Kingdom for a longer period of time, Commonwealth countries do not often rely on United States decisions as a source of precedent, nor do U.S. courts often rely on decisions by court in the U.K. or other commonwealth countries.

In the United Kingdom, the board of directors is a unitary structure. There is no separate "management organ" equivalent to the German management board. Companies Act 1985, § 282 generally requires a public limited company ("plc") to have at least two directors. Companies Act 2006, § 154, continues this requirement; Companies Act 2006, § 155 will add a new requirement that at least one director must be a physical person.

The Companies Act does not directly confer managerial powers on a company's directors. Instead, the directors' authority is specified in the company's charter.[23] In practice, company charters give wide and usually unlimited management authority to the

22 An English version of the Latvian Commercial Code, although not the most recent version, can be found at http://www.ttc.lv/New/lv/tulkojumi/E0040.doc.

23 The basic governing document for a company is given different names in different countries, including Articles of Association (United Kingdom) and Certificate of Incorporation (Delaware, United States). We refer to this basic governing document, which exists in all countries covered by this Report, as a charter.

board of directors. A provision granting this unlimited authority is part of the standard default charter, which is appended to the Companies Act and applies unless a specific company charter provides otherwise (Companies Act 1985, § 8). This standard charter is known as Table A.[24] A recent survey finds that all 100 of the public companies included in the FTSE 100 stock index vest complete management authority in the company's board.

A company's articles can also allow the board to delegate its functions to committees of the board and to managers. Table A, Regulations 71 and 72, provides standard charter terms which provide for delegation. The survey of the FTSE 100 companies found that all 100 companies' charters allow this delegation.

Corporate law in Northern Ireland is included in the Companies (Northern Ireland) Order 1986 (SI 1986/1032), which closely follows the Companies Act 1985. We will not discuss the company law of Northern Ireland in this Report.

Corporate legislation in the United Kingdom does not form a comprehensive code of corporate law. The legislation is supplemented by judge-made law, usually called "common law." This common law can potentially differ between (a) England and Wales; (b) Scotland, and (c) Northern Ireland. However, decisions in one jurisdiction are persuasive in the others, and the differences in the area of corporate law are usually not large. Also, most important decisions on company law are rendered in the courts of England and Wales, especially the courts in London, which is the U.K.'s principal financial centre. We therefore discuss here only the common law of England and Wales.[25]

When procedural rules are relevant, we discuss only the procedural rules applicable in England and Wales. For convenience, we will refer to the full set of statutory and common law that applies in England and Wales as "English" law. The reason for this focus is the overwhelming economic and legal predominance of England, and particularly London, within the United Kingdom as a whole.

The United Kingdom does not have a separate body of corporate law for smaller or privately held companies. Certain distinctions are drawn, however, between plcs and other companies. Primarily, plc companies are permitted to offer shares to the public, and face additional regulatory requirements. Although companies must be plcs in order to be publicly traded, some plcs are privately held. With the exception of Chapter 10 (which discusses nonpublic companies), this Report is limited to the rules applicable to plc-type companies. References to "public companies" include only companies whose shares are publicly traded.

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24 See Companies (Tables A-F) Regulations 1985 (SI 1985/805). With regard to the authority of the board of directors, see Table A, Regulation 70.

25 Technically, and confusingly, in common law countries, the "common law" created through judicial decisions is sometimes further divided into "common law" decisions and "equity" decisions. This distinction arose because England developed two parallel sets of courts with overlapping jurisdiction, called, respectively, "common law" and "equity" courts. The common law courts tended to interpret legislation and prior case law strictly and formally. The equity courts developed a more flexible approach, and sought to do justice in a particular case with less regard to legal formalities. In this Report, we refer to both of these systems of judge-made law as "common law."

Plcs that have carried out a public offering and are listed for trading on the main market of the London Stock Exchange are known as listed companies and must comply with Listing Rules and Disclosure Rules formulated and enforced by the Financial Services Authority. These listing and disclosure rules are an important additional source of regulation, even though they are technically not "law."[26]

The United Kingdom has created, over a period of 20 years, several codes of corporate governance, which have now been collected into a single "Combined Code of Corporate Governance."[27] The provisions of the Combined Code are voluntary, but in most cases, public companies that do not comply must so state annually and explain why they have chosen not to comply. This report was written curing a period in which the 2003 version of the Combined Code was being gradually replaced by the 2006 version. This change occurs over a period of time because the applicability of the new version of the Combined Code depends on when a company's accounting year begins. The differences between the 2003 and 2006 versions of the Combined Code do not affect this report.

United States

The United States is a common law country. It has a federal legal system. Uniquely among the countries we study, the United States has no federal corporate law as such. However, the corporate law of the state of Delaware can be understood as a kind of *de facto* federal law, because most U.S. public companies are incorporated in Delaware. In this Report, we discuss principally the corporation law of Delaware. We occasionally discuss the Model Business Corporation Act, which is a model law that is followed, although not perfectly, in about 25 states.

Important aspects of corporation law have been developed through judicial decisions (common law). These include the principal fiduciary duties of members of the board of directors and many of the procedural rules and rules allocating the burden of proof in corporate law cases.

United States "securities law" is federal, and governs important aspects of what might be considered to be companies law. Federal securities law is binding on all publicly traded companies, regardless of which state they are incorporated in. An example of the manner in which federal securities law can address topics that would otherwise be covered in state corporation law is the Sarbanes Oxley Act of 2002. The Sarbanes-Oxley Act regulates, among other matters, the composition of the board of directors, as between inside and outside directors, and the composition and role of the audit committee of the board of directors.[28] We discuss United States securities law to the extent that it includes rules that affect the liability of directors for breach of duty to the company. We do not discuss securities law in general. Thus, we do not discuss the obligations of directors

26 The Listing Rules are at http://fsahandbook.info/FSA/html/handbook/LR. The Disclosure Rules are at http://fsahandbook.info/FSA/html/handbook/DTR.

27 FINANCIAL REPORTING COUNCIL, COMBINED CODE OF CORPORATE GOVERNANCE (June 2006), *at* http://www.frc.org.uk/corporate/combinedcode.cfm.

28 For a critical assessment of the Sarbanes-Oxley Act, see Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE LAW JOURNAL 1521 (2005).

under securities law to provide disclosure to investors of material information concerning the company.

Delaware does not have a separate corporation law for private companies. It does have some special provisions for closely held companies, included as a separate section of the overall corporation law. We discuss these provisions in Chapter 10 (on nonpublic companies).

Delaware and other states have a special form of legal entity known as a "limited liability company." However, this form of legal entity is a hybrid between a corporation and a partnership and is not really similar to the limited liability company form that exists in Russia. We do not discuss limited liability companies, of the U.S. variety, in this Report.

As in the United Kingdom, the listing rules of the principal stock exchanges (the New York Stock Exchange and the NASDAQ) are a separate source of rules that public companies must follow. Listing rules apply to all listed companies, regardless of which state they are incorporated in. We discuss these rules when relevant.

The United States does not have a voluntary code of corporate governance, that would be similar to the codes in France, Germany, Korea, Russia, and the United Kingdom.

General Assessment of Laws in Comparison Countries

A review of the laws of the comparison countries makes clear that none of them provides an ideal model for Russia to draw on. In a number of countries, the law on the duties of directors is surprisingly ill-developed. For example, the German AktG does not explicitly include a requirement that directors act in good faith. The commentators and courts have implied such a duty from various sources, including the general civil law requirement of good faith for parties to a contract, but its statutory basis and scope remains unclear. In France, there is no explicit statutory duty of directors to the company and only limited case law developing the nature and scope of their duties. Germany has a two-tier board system, in which the supervisory board has more limited powers than a Russian board of directors.

With regard to derivative suits by shareholders to enforce the duties of directors, procedural obstacles to bringing these suits, including "loser pays" attorney fee rules, have made these suits uncommon in a number of countries, including Canada, Germany, and the U.K. The United States has shareholder suits in substantial numbers, but under complex rules that Russia would be advised to avoid rather than copy. In other countries, there has been a trend over time toward reforms to encourage derivative suits, including recent reforms in Germany (2005) and the U.K. (in the Companies Act 2006) and earlier reforms in Japan and Korea.[29]

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29 Although derivative suits (suits by shareholders, brought in the name of the company, seeking to enforce directors duties to the company) are uncommon in Canada and rare in the United Kingdom, there are a reasonable number of direct suits by shareholders under the Canadian oppression remedy and the United Kingdom unfair prejudice remedy. These remedies can provide an indirect way for shareholders to obtain relief for directors' noncompliance with their duties to the company.

Sometimes, a particular country has found a good solution to a specific problem, which Russia can learn from. For example, several countries have adopted the concept of a "shadow" or *de facto* director, to address the problem -- which we understand to be common in Russia as well -- of a person who in fact adopts decisions for a company, yet holds no official position. Italy has addressed the problem of improper settlement of shareholder suits under company law by requiring the settlement to be approved by shareholders.

Sometimes no comparison country offers an effective solution to a problem faced in Russia. For example, among the countries which allow a company to be managed by another company, none has addressed the circumstances under which the directors and managers of the managing company should be liable to the shareholders of the managed company. No country faces Russia's unique problems with government-appointed directors, who at the present time face the potentially conflicting obligations to accept instructions from superiors in the government and to act only in the interests of the company.

As a result, we recommend learning from an overall assessment of the experience in all of the comparison countries, and not relying primarily on any one country as the basis for amendments to the Russian law. In particular, while important parts of Russian law have a strong German influence, German company law has important differences from Russian law, has relatively ill-developed rules on the scope of directors' duties, and thus does not, on the whole, offer a better model for regulation of the duties of directors and officers than other comparison countries.

Subchapter 1.2. Concept of reasonableness and good faith

Issue: How should the criteria of reasonableness and good faith be determined?

Russian context

The terms “good faith” and “reasonableness” are frequently encountered in Russian civil law, for example in the Civil Code provisions on exercise of civil rights and on the concept of a good-faith purchaser,[30] and the general principle that all participants in civil commerce are obligated to act reasonably and in good faith.[31] Civil Code art. 10(3), provides that “the reasonableness of actions and the good faith of the participants in civil

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30 For further information, see, for example, For further information, see Evgeny Bogdanov*, The Category of Good Faith in Civil Law*, RUSSIAN JUSTICE, No. 9 (1999), at 12-14 (Евгений Богданов, *Категория «добросовестности» в гражданском праве*, РОССИЙСКАЯ ЮСТИЦИЯ); S. A. Ivanova, *Problems in the Realization of the Principle of Social Justice, Reasonableness and Good Faith in the Law of Obligation*, LAW AND ECONOMICS , No. 4 (2005), at 29-34 (С.А. Иванова, *Некоторые проблемы реализации принципа социальной справедливости, разумности и добросовестности в обязательственном праве*, ЗАКОНОДАТЕЛЬСТВО И ЭКОНОМИКА); M. I. BRAGINSKIY AND V. V. VITRYANSKIY, CONTRACT LAW volume 1 (Statut Press, 2000) (М.И. БРАГИНСКИЙ AND В.В. ВИТРЯНСКИЙ, ДОГОВОРНОЕ ПРАВО, Статут).

31 For an opposing view, see V. I. YEMELYANOV, REASONABLENESS, GOOD FAITH AND NON-ABUSE OF CIVIL RIGHTS (Lex-Kniga Press, 2002) (В.И. ЕМЕЛЬЯНОВ, РАЗУМНОСТЬ, ДОБРОСОВЕСТНОСТЬ, НЕЗЛОУПОТРЕБЛЕНИЕ ГРАЖДАНСКИМИ ПРАВАМИ, Лекс-Книга).

legal relations shall be presumed.. Thus, a person who acts on behalf of a legal entity in accordance with law or its founding documents must act in the interests of the legal entity, in good faith and reasonably (Civil Code art. 53(3), JSC Law art. 71).

Despite the widespread use of these terms, their meaning in practice is often problematic. This section will discuss the following issues:

- the manner in which "good faith" and "reasonableness" are defined;
- the relationship among "good faith," "reasonableness" and fault; and
- the approximate criteria for "good faith" and "reasonable" behavior on the part of members of a company's management organs.

Defining the Concepts of "Good Faith" and "Reasonableness"

Russian legislation does not define the concepts of good faith and reasonableness; instead, the so-called "golden rule of interpretation" is used, whereby the words and expressions used in legislation are to be accorded their standard, everyday meanings.[32] In Russian, the term "good faith" is considered to be synonymous with honesty and truthfulness. Only an individual who honestly fulfills his or her duties can be said to act in good faith. The word "reasonable" is taken to mean "prudent," or "based on reason". It would thus seem that, in light of the specific nature of the position held by a member of a company's governing organ, his conduct must be compared not to the conduct of any ordinary individual but, instead, to the conduct of a person occupying a similar position.

The terms "reasonableness" and "good faith" are closely related in that they both involve ethical categories of evaluation. In addition, each is directed at the attainment of the general purposes of civil law -- ensuring that a balance exists between the interests of participants in civil legal relations. These concepts apply only in the context of individuals' actions in concrete real-life situations involving other members of society.

The Relationship between the Concepts of Good Faith, Reasonableness, and Fault

There is no significant theoretical research on the relationship between the concepts of "good faith" and "fault" in Russian civil law. During the Soviet period, civil law relied on the criminal law concept of fault, albeit without justification. Some authors point out that the concept of fault is already included within the concept of "bad faith".[33] However, even if action in bad faith necessarily involves fault, fault can also exist without bad faith.

One source suggests that the fault of a person in modern civil law is determined "using an abstract model of expected conduct in this or that situation for *participants in property transactions acting reasonably and with good faith*".[34] But if this is correct, it is not clear what the general civil law requirement of fault adds to the conditions for civil liability,

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32 *See* M. I. BRAGINSKIY AND V. V. VITRYANSKIY, CONTRACT LAW volume 1 (Statut Press, 2000) (М.И. БРАГИНСКИЙ AND В.В. ВИТРЯНСКИЙ, ДОГОВОРНОЕ ПРАВО, Статут).

33 *See* V. I. YEMELYANOV, REASONABLENESS, GOOD FAITH AND NON-ABUSE OF CIVIL RIGHTS (Lex-Kniga Press, 2002) (В.И. ЕМЕЛЬЯНОВ, РАЗУМНОСТЬ, ДОБРОСОВЕСТНОСТЬ, НЕЗЛОУПОТРЕБЛЕНИЕ ГРАЖДАНСКИМИ ПРАВАМИ, Лекс-Книга).

34 *See* M. I. BRAGINSKIY AND V. V. VITRYANSKIY, CONTRACT LAW volume 1 (Statut Press, 2000) (М.И. БРАГИНСКИЙ AND В.В. ВИТРЯНСКИЙ, ДОГОВОРНОЕ ПРАВО, Статут).

once a person is found to have acted unreasonably or in bad faith. Put differently, it is not clear under what circumstances a person can act unreasonably or in bad faith, and yet be said not to have the degree of fault required for civil liability. Conversely, if a person acts with civil fault, it is not clear under what circumstances, the person could still be found to have acted reasonably and in good faith.

Approximate Criteria for "Good Faith" and "Reasonable" Behavior

The use in the law of moral norms, such as good faith and reasonableness, is complicated by the abstract nature of these concepts. Neither legislation nor judicial decisions provides a more precise definition. Indeed, it has been suggested that "the legal definition of any kind of parameters of the concept of 'good faith . . . is theoretically impossible".[35] This same view applies to the category of "reasonableness".[36] Russian legislation does not include the concept of fiduciary relations, to which one might look for guidance in determining when actions by members of a governing organ are considered to be in good faith.

It may be possible for legislation or judicial decisions to establish non-exhaustive criteria for when conduct is considered to be bad-faith (unreasonable) in concrete situations. However, this approach has not yet been adopted. Given the absence of meaningful Russian legal precedent on how to define the degree of good faith (reasonableness) that should be required of members of company management organs, attention can instead be focused on the provisions of the Code of Corporate Governance and on the charters of some joint-stock companies.

The Code of Corporate Governance is advisory in nature. It defines the criteria for reasonableness and good faith for members of a company's management organs as follows: persons are considered to have acted reasonably and in good faith if they had *no personal interest in the decision-making* and *carefully considered all information* essential for arriving at a decision. Moreover, the circumstances should indicate that they *acted exclusively in the interests of the company*.

The criteria for bad faith on the part of the members of the board of directors can be found in some company charters. Some criteria are:

- failure to attend board of directors meetings without good cause;
- failure to implement decisions of the board of directors or shareholder meetings;
- failure to abide by company rules, business principles and ethical norms; and

35 V. V. Vitryanskiy, *The Civil Code and the Court*, BULLETIN OF THE SUPREME ARBITRAZH COURT OF THE RUSSIAN FEDERATION, No. 7 (1997) at 132 (В.В. Витрянский, *Гражданский кодекс и суд*, ВЕСТНИК ВЫСШЕГО АРБИТРАЖНОГО СУДА РОССИЙСКОЙ ФЕДЕРАЦИИ).

36 *See* M. I. BRAGINSKIY AND V. V. VITRYANSKIY, CONTRACT LAW volume 1 (Statut Press, 2000) (М.И. БРАГИНСКИЙ AND В.В. ВИТРЯНСКИЙ, ДОГОВОРНОЕ ПРАВО, Статут) ("There is no possibility of uniformly establishing the scope of the concept [of reasonableness] without resorting to other similar evaluative categories").

- participating in a transaction involving a conflict between the person's individual interests and the company's interests, without obtaining the approval required by the JSC Law.[37]

Judicial decisions are limited, but indicate that the following criteria can demonstrate a lack of good faith and reasonableness:

- entering into a transaction without considering the company's interests,[38] and
- exhibiting lack of interest in fulfilling one's duties.[39]

Canada

In Canada, corporate statutory law contains two principal fiduciary duties owed by directors and officers to their companies: a duty of care, diligence and skill; and a duty of honesty and good faith (see, for example, CBCA § 122(1), OBCA § 134(1)). These statutes do not contain a requirement of reasonableness, as such. However, this statement of fiduciary duty is understood to be only partial, and to supplement, rather than replace, the development of principles of fiduciary duty by the courts under judge-made "common law."

The common law derived from judicial decisions specifies additional fiduciary duties of directors. The classic statement of the law on this point is set out in *Canadian Aero Services Ltd. v. O'Malley* [1974] S.C.R. 592, where the Supreme Court of Canada said "a fiduciary relationship…in its generality betokens loyalty, good faith and avoidance of a conflict of duty and self-interest". In instances of alleged self-dealing Canadian courts generally focus on the potential violation of the fiduciary duty established by the common law rather than being concerned with a violation of the statute as such. This approach, of looking first to the common law, even when there is a potentially relevant statutory provision, is consistent with the legislative intent underlying the statutory provisions setting out basic duties of directors, which was that the statute was not intended to replace the common law, or to constitute a complete statement of the duties of directors.

With regard to the first duty, directors, when making decisions on behalf of the company, must "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances" (CBCA § 122(1)(b)). The reference to "reasonably prudent person" is understood to impose on directors a duty to possess a

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37 See M. V. SAMOSUDOV, COMPENSATION TO MEMBERS OF THE BOARD OF DIRECTORS. THE PRACTICE IN RUSSIA (2003) (М.В. САМОСУДОВ, ВОЗНАГРАЖДЕНИЕ ЧЛЕНАМ СОВЕТА ДИРЕКТОРОВ. РОССИЙСКАЯ ПРАКТИКА).

38 Decision of the Federal Arbitrazh Court of the Moscow District No. KG-A40/547-02 (Feb. 19, 2002) (Постановление Федерального арбитражного суда Московского Округа от 19 февраля 2002 г, № КГ-А40/547-02).

39 Decision of the Federal Arbitrazh Court of the Volgo-Vyatskiy District No. A43-2160/03-25-102 (Sept. 9, 2003) (Постановление Федерального арбитражного суда Волго-Вятского Округа от 09.09.2003, № А43-2160/03-25-102).

normal degree of business skill and experience. A poorly qualified director cannot escape liability simply because he did his best.[40]

Courts and commentators are divided on whether "comparable circumstances" requires judges to take into account the skills of a particular director, or instead refers to the factual circumstances in which the decision was made. For example, should the level of diligence be relaxed if a quick decision was required, compared to a situation in which the directors had time for investigation and careful deliberation?[41]

Canadian corporate law also requires directors to act honestly and in good faith with a view to the best interests of the corporation (CBCA § 122(1)(a), OBCA, § 134(1)(a)). "Good faith" is not defined in either the CBCA or the OBCA. Directors who exercise their powers to advance their own interests obviously breach the duty of honesty and good faith. A more difficult situation is where a decision plausibly was taken to advance the corporation's interests, but also provides a personal benefit to the directors. The directors will claim they have acted in good faith. In deciding whether the directors have breached their duty, the court will seek to ascertain which motive was dominant -- a motive to benefit the corporation, or a motive to benefit themselves. The courts will consider whether there were reasonable grounds for the directors' claim that they acted primarily in the interests of the corporation.[42]

France

For the most part, the Code de Commerce does not phrase the duties of directors in an affirmative fashion. Commentators and case law state that directors have a fiduciary duty (bonne foi, or good faith) to the company.[43] This duty can be violated through disloyalty (*déloyauté*) if a director acts to further his personal interests, rather than the company's interest (*intérêt sociale*)[44]

French corporate law does not specify how directors should behave. It focuses instead on various breaches of the law. It does not use the terms reasonableness or good faith, as such.

One-Tier Board

For companies with a one-tier board, there is a board of directors (*conseil d'administration*) and its chairman (*president*). The board appoints the Chief Executive Officer (CEO) (*directeur général*).[45] It is possible but not necessary for the CEO to be a member of the board. It is also possible for the CEO to also be the chairman of the board. In this case, the CEO is called the *président directeur general,* or *PDG)*. The

40 MARKUS KOEHNEN, OPPRESSION AND RELATED REMEDIES 220, 223 (2004).

41 *Idem* at 221.

42 *See* Teck Corporation v. Afton Mines Ltd., [1972] 33 D.L.R.3d 288 (Can.).

43 *See* YVES GUYON, 1 DROIT DES AFFAIRES ¶ 324 (11th edition 2001); Cass. comm. 27 févr. 1996 no. 439; Cass. comm. 12 mai 2004.

44 *See* TERRE ET AL., LE DIRIGEANT DE SOCIETE: RISQUES AND RESPONSABILITES ¶ 061-11 (2002).

45 Note the different use of the words "*director*" in U.S. and U.K. law and "*directeur*" in French law.

board can also appoint "assistant general managers" (*directeurs généraux délégués*). These managers, like the CEO, may or may or not be members of the board.

The main provision on liability is Code de Commerce art. L. 225-251. It refers only to the members of the board and to the CEO. It states:

> the directors and the CEO shall be individually or jointly and severally liable to the company or third parties either for infringements of the laws or regulations applicable to public limited companies, or for breaches of the memorandum and articles of association, or for tortious or negligent acts of management.

The meaning of the term "tortious or negligent acts" is not defined in the statute. Instead, it is left to be interpreted by courts and by commentators. It has been interpreted to include both actions and failures to act. Actions or failures to act can give rise to liability if they are negligent or tortious and cause harm to the interest of the company (*intérêt de la société*). A conflict of interest on the part of directors or a controlling shareholder is one basis for the courts to consider that an action was not in the interests of the company. Negligence can occur both in taking actions oneself (*fautes de gestion*) and in supervising the actions of others (*fautes de surveillance*).[46]

Article L. 225-251 of the Code de Commerce does not apply to assistant general managers, unless they are members of the board). Their liability is therefore based on general principles of civil law established in the French Civil Code).[47]

Two-tier Board

If a French company chooses to adopt a two-tier board structure, it will have a supervisory board and a management board (*directoire*). The company can also choose to have a sole managing director instead of a multi-member management board. The members of the management board face liability under Article L. 225-251, which is quoted above.[48]

The supervisory board (*conseil de surveillance*) is subject to a slightly different standard of liability. Article L. 225-257 of the Code de Commerce states that:

> members of the supervisory board shall be liable for negligent or tortious acts committed by them in a personal capacity in the performance of their duties. They shall incur no liability for acts of management or the result thereof. They may be held liable in civil law for criminal offences committed by members of the management if, having been aware thereof, they did not report these offences to the general meeting.

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46 FRANCIS LEFEBVRE, MEMENTO SOCIETES COMMERCIALES ¶ 8483 (2006); DALLOZ, CODE DE SOCIETES 698 (21st edition 2005). With regard to liability for failure to act, see CA Paris, Sept. 19, 1995, Dr. soc. janv. 1996, no 19; TERRÉ ET AL. (2002), *supra* note 45, at ¶ 061-12.

47 FRANCIS LEFEBVRE, MEMENTO SOCIETES COMMERCIALES ¶ 8824 (2006).

48 C. COM. article L. 225-256 (Fr).

Germany

German corporate law contains two principal duties of directors toward their companies: an explicit duty of diligence and an implicit duty of loyalty. The duty of loyalty is not directly stated in the AktG, and instead has been developed through judicial decisions. The AktG does not contain a requirement of reasonableness, as such, or a requirement of good faith, as such.

Duty of Care and Diligence

With regard to diligence, AktG § 93 provides for a duty of care and responsibility. It states that "In conducting business, the members of the management board shall employ the care of a diligent and conscientious manager." AktG § 93 also contains a list of specific instances in which the members of the management board can be liable, such as when they approve an unlawful payment of dividends.

AktG § 116 states that this duty of care and responsibility established by AktG § 93 shall apply analogously to members of the supervisory board. Thus, the standard for measuring directors' duties can be considered to be the same, regardless of which board they serve on. At the same time, the supervisory board and the management board have different responsibilities, so the practical content of these duties will be different. Similarly, for the duty of loyalty, which is derived from judicial decisions, the decisions give no reason to believe that the duty would be different for a supervisory director than for a management director.

In 2005, amendments to the AktG added a defense to a claim that a director violated AktG § 93, which is considered to be analogous to the United States business judgment rule. The concept of a business judgment rule defense to liability had previously been recognized in a court decision (see discussion in subchapter 1.3). AktG § 93 now provides that:

> There is no violation of this duty when the member, when taking a business decision, could be reasonably presumed to be acting to the benefit of the company on the basis of adequate information.

The elements of this statutory "business judgment rule" defence have not been defined in more detail by the law, and there are as yet no relevant court decisions interpreting the new statutory provision.

Under AktG § 93, directors are required to act for the benefit of the company (*Gesellschaftswohl*). The meaning of this term is uncertain, but it should probably be interpreted to be identical with the term *Unternehmensinteresse* (interest of the business), which had been previously used in the AktG (though not since 1965). The concept of benefit of the company is a broad concept, which is not limited to the interests of shareholders only, but also includes the interests of employees and the general public.[49]

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49 UWE HÜFFER, AKTIENGESETZ § 76 ¶ 12 (7th edition 2006). This broad view may be related to the German practice of employee co-determination, in which employee representatives form half of the membership of the supervisory boards of large public companies.

Duty of Loyalty

Directors may also be liable, both under the AktG and under criminal law, if they violate their duty of loyalty to the firm.[50] This duty can be considered to be similar to the duty of good faith under Russian law. It is referred to in judicial decisions, but is not directly based on a specific provision of the AktG. Commentators have argued that a statutory basis can be found under AktG § 76 (which refers to the board's responsibility for management of the company), § 84 (which discusses appointment of the management board; with the idea being that fiduciary duty may follow from this appointment), or § 93 (which we have quoted above, and can be broadly understood to be violated if the interests of the company are harmed). The duty of loyalty can be understood to derive the general civil law duty of "Treu und Glauben" (good faith) for parties to a contract.[51] The idea is that the duty of loyalty follows from appointment as a director, and from the fact that the directors have a duty to act in the interests of the company, and are responsible for managing someone else's property.[52]

Some explicit provisions of the Aktiengesetz are often considered to be particular instances of this general implicit duty of loyalty: These include:

- AktG § 87 I requires the remuneration of directors to be reasonable in relation to the director's duties and the company's situation.
- AktG § 88 stipulates that a member of the management board cannot compete with the firm. Thus, members of the management board may not run a commercial business, or enter into commercial transactions on their own or someone else's behalf, unless they receive permission from the supervisory board.
- AktG § 93 I 3 requires members of the management board to maintain confidentiality for business secrets.

While the duty of loyalty is discussed by commentators, the scope of the duty remains unclear. Case law applying it to joint stock companies in the Supreme Federal Court is rare, which is likely related to the absence of an effective mechanism for shareholders to bring a derivative suit (2005 amendments to the AktG liberalize the derivative suit procedure). The recent decision in the Mannesmann criminal case (discussed later in this Report) is probably the clearest statement so far.[53] The other cases involving the duty of loyalty in joint stock companies are old. Some do not explicitly use the term "duty of loyalty," but instead simply state that a specific transaction by a director was not permitted.[54]

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50 BGH JZ 2006, 560, 561 (speaking of a waste of funds violating the duty of loyalty–*treuepflichtwidrige Verschwendung*).

51 BGB [German Civil Code] § 242.

52 *See* Wolfgang Hefermehl and Gerald Spindler, *in* 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 76, ¶ 14 (Bruno Kropff and Johannes Semler editors., 2nd edition, 2004); HÜFFER (2006), *supra* note 49, at § 84, ¶ 9.

53 BGH 21.12.2005 - Az: 3 StR 470/04, NJW 2006, 522.

54 See RGZ 96, 53 (1919) (decision of the German Imperial Court on the purchase of ships from a company owned by a director where the company paid an excessive commission); BGHZ 20, 239 = NJW

There has been no effort by the courts to define the duty of loyalty. Instead, whether a violation has occurred will depend on the facts of each case.

There are also cases concerning the duty of loyalty in limited liability companies. Most of these seem to concern the duty not to compete with the company, which is explicitly stated in the joint stock company law but is not explicitly stated in the limited liability company law.[55] There is also case law prohibiting management directors from making personal use of business opportunities that were also available to the company.[56]

Application to Other Persons

Managers who are not members of the management board are not subject to the duties of directors specified in AktG § 93. Generally, their duties are determined by the contract of employment.

Korea

The Korean Commercial Code (KCC) does not phrase the duties of directors in an affirmative fashion. It speaks instead about the manner in which directors can breach their duties. It does not use the term reasonableness as such. It uses the term "bad faith" rather than the term "good faith".

There are two principal ways in which a director can breach duties owed to a company: through negligence and through bad faith (KCC art. 401, ¶ 1).

While, in theory, simple negligence can produce liability, in practice, the courts are reluctant to second-guess business decisions. Without directly saying so, the Korean courts may follow an approach that is similar to the business judgment rule applied in the United States.[57]

An act of bad faith generally involves willful misconduct. Thus, under Korean law, the concept of bad faith, as used in KCC art. 401 does not have the same meaning as the absence of good faith.

United Kingdom

The fiduciary duties of U.K. directors were developed through judicial decisions, and, until the adoption of the Companies Act 2006, were not stated in the companies statute. We first discuss existing case law, and then the new codification. The principal duties

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1956, 906 (hidden payment of remuneration, violating the AktG requirement for disclosure to the supervisory board). Other early cases mention the duty of loyalty but are centrally concerned with other issues. See, for example, BGHZ 10, 187 = NJW 1953, 1465; BGHZ 13, 188 = NJW 1954, 998; BGHZ 49, 30.

55 See, for example, BGH NJW 1986, 586; BGH DStR 1997, 1053.

56 BGH GmbHR 1989, 365.

57 *See* Hwa-Jin Kim, *Directors Duties and Liabilities in Corporate Control and Restructuring Transactions: Recent Developments in Korea*, 2006 OXFORD UNIVERSITY COMPARATIVE LAW FORUM 2, *at* http://ouclf.iuscomp.org/articles/kim.shtml.

owed by directors to a company are the duties of care and loyalty. The terms reasonableness and good faith are not expressly included in customary statements of these duties, as such. Nevertheless, the duty of care includes a duty of reasonable diligence, and the duty of loyalty includes an obligation to act in good faith.

The degree of diligence that will be considered to be "reasonable" is not defined in English law. However, judicial decisions provide some guidance on what is expected from directors. Here is one recent statement of the duty of care:

> "A person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. That duty will vary according to the size and business of the particular company and the experience or skills that the director held himself or herself out to have in support of appointment to the office."[58]

Similar points were made more recently in *Equitable Life* v. *Bowley* with respect to non-executive directors:[59]

> [35] There is a considerable measure of agreement about the duty owed in law by a non-executive director to a company. In expression it does not differ from the duty owed by an executive director but in application it may and usually will do so.
>
> [36] *In Re D' Jan of London Limited* [1993] BCLC 646 Hoffmann LJ said, at page 648,
>
> > ... the duty of care owed by a director at common law is accurately stated in sec. 214(4) of the Insolvency Act 1986. It is the conduct of:
> >
> > > ... a reasonably diligent person having both –
> > >
> > > (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and
> > >
> > > (b) the general knowledge, skill and experience that that director has.
>
> [37] Thus the first requirement is a [general] test, the second looks to the actual knowledge, skill and experience of the director in question.
>
> [38] But this test provides no answer to the question what are the "functions" of a non-executive director of a company such as Equitable? There may, of course, be specific "functions" undertaken by a non-executive director. Mr Sclater was "President" of Equitable. Other applicants were members of committees such as the Audit Committee or Investment Committee. For the purposes of this judgment, however, it is not suggested that such roles gave rise to any relevant special function and it is sufficient to consider the functions of the applicants in more general terms.

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58 *In re* Barings plc (No. 5) [1999] 1 B.C.L.C. 433, 488b (quoting Daniels v. Anderson (1992) 16 A.C.S.R. 607 (Ct. App. New S. Wales, Austl.)).

59 [2003] EWHC. 2263 (Comm.); [2004] 1 B.C.L.C. 180, at [35]-[39] (opinion of Langley, J.).

> [39] Mr Milligan QC referred me to another general statement about the duties of directors which I find helpful as it both expresses what may be expected of a "reasonably diligent" director and acknowledges the obvious qualification that what the test requires must depend on the particular circumstances before the court. The reference is in the judgment of Morritt LJ in *Re Barings Plc (No 5)* [2000] 1 BCLC 523 at page 535 where the Court of Appeal approved the summary given by Jonathan Parker J at first instance in these terms:
>
> > "(i) Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.
> >
> > (ii) Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.
> >
> > (iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director's role in the management of the company."

The concept of "good faith" is not defined in English law. In general, it is assumed to exist, and it is up to the plaintiff to instead prove bad faith. Bad faith involves conscious intention or motive to deviate from a director's duty to act in the interests of the company.[60] The existence of a personal interest in a transaction is evidence that a director may be acting in bad faith, but is not, without more, proof of bad faith.[61] The overlap between the requirement of good faith and the requirement of loyalty is a complex one.[62]

Codification of Duties of Care and Loyalty

The Companies Act 2006 will, for the first time, codify the fiduciary duties of directors.[63] The new provisions are intended to codify rather than change the existing common law duties of care and loyalty, with two exceptions. The first change is that a self-dealing transaction will need to be disclosed to and approved only by the board, not by shareholders. The company will not need to disclose to shareholders the reason for the director's conflict, but will still have to disclose the *transaction itself*.[64] The second change permits *board* (rather than shareholder) authorisation of most conflicts of interest

60 See, for example, *Re Smith and Fawcett Ltd.* [1942] Ch. 304; *Regentcrest plc (in liquidation)* v. *Cohen* [2001] 2 BCLC 80 at p. 105.

61 See *Bray* v. *Ford* [1896] A.C. 41.

62 Matthew Conaglen, *The Nature and Function of Fiduciary Loyalty*, 121 LAW QUARTERLY REVIEW 452, 472-75 (2005).

63 *See* Companies Act 2006, §§ 170-181 (United Kingdom) (codifying existing duties).

64 *Id.* §§ 177, 182.

arising from a director's dealings with third parties (for example, personal exploitation of business opportunities that might also have been available to the company).[65] The Companies Act 2006 also includes a new statutory duty of disclosure.[66]

United States

The two principal fiduciary duties of directors of corporations in the United States are the duty of care and the duty of loyalty. While some recent Delaware cases speak of a duty of good faith, it is unclear to what extent this duty differs from the traditional duty of loyalty, which already imposes a requirement of good faith.[67]

The fiduciary duties of directors were first elaborated by common law judges. Indeed, the company laws of many states, including Delaware nowhere state these duties. Even when statutory statements of fiduciary duty exist, as in the Model Business Corporation Act, they are highly general and judges must fill in the details. The Model Business Corporation Act contains the following bare statement of a director's duty of loyalty:

> Each member of the board of directors . . . shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.[68]

The Model Business Corporation Act also defines the duty of care:

> The members of the board of directors . . . shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.[69]

The concept of a "reasonable belief" is not defined.

The concept of good faith is often taken to mean that the director acts without a conflict of interest, and does not intentionally violate the law or consciously disregard his duties as a director. A recent Delaware Supreme Court case explains that the duty of good faith can be violated in three ways:

- a director "intentionally acts with a purpose other than that of advancing the best interests of the corporation,"
- a director acts with intent to violate applicable positive law, or
- a director "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[70]

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65 *Id.* § 175(5-6).

66 *Id.* §§ 182-187.

67 This discussion of the fiduciary duties of directors is adapted from Bernard Black, *The Core Fiduciary Duties of Outside Directors*, ASIA BUSNESS LAW REVIEW, 3-16 (July 2001), *at* http://ssrn.com/abstract=270749, but has been updated to include the concept of a duty of good faith, which is partially distinct from the duty of loyalty.

68 MODEL BUSINESS CORPORATION ACT § 8.30(a) (2005).

69 *Id.* § 8.30(b).

The first two aspects of good faith are part of the traditional duty of loyalty. The third prong is not. However, it is difficult to show that a director has consciously disregarded his duties. Moreover, especially for non-executive directors, it is rare for them to have intentionally acted in violation of law. Thus, in practice, the principal basis for finding a lack of good faith is that a director has acted with a conflict of interest, and approved a decision that produced a private benefit to the director.

The statement above of the duty of care is misleading. It suggests that the liability rule for breach of this duty of care is similar to the general liability rule for torts (actions that harm others) – that is, whether the director has been negligent (unreasonable) in carrying out this duty. In fact, this is not the test for liability under the duty of care.

Instead, in the United States, the courts apply a defense known as the business judgment rule. Under this rule, they usually assess only whether the directors were reasonably informed. If the directors were reasonably informed, the courts do not assess whether the directors' decisions were reasonable as a substantive matter. Put differently, the duty of care is mostly an aspirational statement about how directors should try to act. It is not a basis for liability if the directors fall short of this standard.[71]

Summary and recommendations

The table below summarizes the core duties owed by directors in the countries we considered, and compares these duties to the duties of reasonableness and good faith contained in the Russian Civil Code. With some oversimplification, we treat the common law duty of care as comparable to the Russian Civil Code requirement of reasonableness and to the rules in some countries that establish liability of directors for negligence. We also treat the common law duty of loyalty as comparable to the Russian Civil Code requirement of good faith, and to the concept that a director must act in the interests of the company, when these conflict with his personal interests. The table includes both express statutory duties and duties that are derived from judicial decisions.

70 *In re The Walt Disney Co. Derivative Litigation*, 906 A.2nd 27, 67 (Del. 2006), affirmed by the Delaware Supreme Court, 906 A.2nd.27 (2006).

71 *See* Subchapter 1.3 for a discussion of the business judgment rule.

Overview of Duties of Directors under Company Law

Country	Duty of Care or Reasonablenes s	Duty of Loyalty or Good Faith	Duty of Disclosure	Duties apply to senior managers *who are not directors*
Russia	X	X		To members of executive organ
Canada	X	X		X
France - one-tier board	X	X	*	To CEO
France - two-tier board	X	X	*	To members of management board
Germany	X	X	*	To members of management board
Korea	X	X		No
United Kingdom	X	X	X, *	X
United States	X	X	X	X

* France and Germany do not have a duty of disclosure as such, under company law. However, European Union Directive 2006/46/EC requires member states, by 2008, to adopt rules providing for disclosure by public companies of conflict of interest transactions.[72]

Russia's approach is similar, in broad outline, to those of the comparison countries. Thus, major changes are not appropriate. In our judgment, there is no need to amend the Civil Code. At the same time, we recommend specifying in somewhat greater detail the meaning of the general concepts of reasonableness and good faith. We also recommend adding a duty of directors to disclose any conflicts of interest they may have.

Liability based on fault

Russia regulates the actions of directors and managers in two distinct ways. Each, we believe, is important. First, Civil Code art. 53 and JSC Law art. 71 establish duties of managers and directors, for which liability is based on fault. Second, JSC Law chapter 11 establishes procedures for approval of specified transactions, without regard to fault. Except as specified otherwise, the discussion in this and succeeding chapters is limited to fault-based liability.

Regulation of potential conflict of interest transactions

JSC Law chapter 11 establishes procedures for approval of a specified class of transactions, in which a conflict of interest may exist, without regard to fault and, indeed, without regard to whether the directors or managers have an actual conflict-of-interest with regard to a specific transaction. We were not advised by CCMD of major problems in the operation of these important rules.

72 *See* Subchapter 1.5 for a discussion of these rules.

We were advised that these rules sometimes cover transactions which do not involve a conflict of interest. This is to be expected based on the nature of the rules. The greater concern would be if there are classes of transactions that involve a conflict of interest, but are not reached by these approval procedures. At the same time, we believe it may be appropriate to allow companies to exempt small, de minimis transactions from the current requirements for approval by non-interested members of the board of directors. We present a specific proposal in subchapter 1.4.

Duty of reasonableness

We recommend that the concept of reasonableness should explicitly include the obligation to become reasonably informed before making a decision. This should be stated in the JSC Law. The amount of information that is reasonable will, of course, depend on the circumstances. It is in the nature of business decisions that they must often be made with incomplete information, and that even when more complete information might be available, the delay needed to gather more complete information will be costly. Viewed at the time of the decision, there will be times when directors reasonably decide to decide, based on their current information, rather than to delay in order to obtain additional information.

We do not recommend specifying the standard against which reasonableness is to be measured. This can be left to the courts to determine.

Business judgment rule

A number of jurisdictions have adopted some form of the "business judgment rule," even if not the strong form found in the United States. Sometimes, this rule is explicit, sometimes it can be inferred from decided cases. The core idea, which we believe to be sound is that if directors become reasonably informed, and act without a conflict between the company's interests and their own interests, the courts should give a high degree of deference to their decisions, in order to encourage directors to take risks, which may turn out to be wildly successful or wildly unsuccessful. If directors face a significant risk of being liable for failed decisions, they will be reluctant to take risks, and this will harm rather than benefit shareholders on average.

We recommend that Russia adopt a form of the business judgment rule, in which if directors are reasonably informed, and adopt a decision that does not personally benefit themselves, their fellow directors, or the company's controlling shareholders, there should be a strong presumption that they have acted reasonably. As long as there is no evidence of a conflict of interest, the plaintiffs should be required to show that no rational director could have adopted the decision, in order for the court to find that the directors are liable for failure to act reasonably.

The core idea is that even if the directors have acted foolishly, the risk of such action is an ordinary business risk, that shareholders can fairly be asked to assume. If the law creates a significant risk that directors may be found liable for foolish decisions, they may respond by becoming risk averse. They may make fewer large mistakes, but they will also have fewer large successes.

We discuss the legal presumptions that should apply with regard to the business judgment rule, in subchapter 1.3.

Beyond this, we do not currently see the need to add additional detail to the concept of reasonableness.

Duty of good faith

We recommend specifying in the law the core elements that a director must satisfy, in order to be considered to have acted in good faith. In our judgment, the following are the principal ways in which a director or manager can violate the duty of good faith:

- Engaging in a transaction which involves a direct or indirect conflict of interest without appropriate disclosure and approval.
- Intentional or knowing (zavedomo znaya) violation of the JSC Law or other laws.
- Completion of action, or failure to act, while knowing (zavedomo znaya) that the action or failure to act is opposed to the interests of the company.
- Intentional or knowing (zavedomo znaya) disregard of one's duty to the company.
- Taking improper advantage of a business opportunity that could also have been available to the company.

The requirement to disclose and obtain approval of a conflict of interest transaction applies to any transaction, involving the company or an affiliated or dependent company, in which a director or manager, or his affiliated persons, has a direct or indirect self-interest, unless the conflict has been disclosed in advance to the company and has been approved by non-conflicted members of the board of directors, is fair to the company, and has been approved in compliance with JSC Law chapter 11, if this chapter is applicable.

The concept of intentional or knowing violation of law includes cases in which this violation is intended to benefit the company (for example, a violation of antitrust law, product safety law, or environmental law will often be profitable for the company). It also includes refusal to take actions which the board of directors is required to take under the JSC Law, such as convening an annual general meeting of shareholders, convening an extraordinary general meeting of shareholders which has been requested by shareholders in accordance with the procedure established in the JSC Law, refusing to submit the company's annual financial statements to shareholders for their approval, and so on.

The concept of intentional or knowing disregard of one duty would include extreme neglect, such as repeated failure to attend meetings of the board of directors, without a sufficient reason for absence; or repeated refusal to adopt decisions on matters which are brought to the board for decision and require some action. It would also include intentional or knowing violation of the duties established by the JSC Law; including the duty to act reasonably and in the interests of the company, and the duty to disclose a conflict of interest.

The concept of taking improper advantage of a business opportunity will apply if there is a reasonable possibility the company would be interested in this opportunity, unless the opportunity has been disclosed in advance to the company and the non-conflicted members of the board of directors have agreed, on behalf of the company, that the director or manager can pursue the opportunity.

We discuss the legal presumptions that should apply to different aspects of the duty of good faith in subchapter 1.3. The proposed definition of the concept of good faith draws on the concept of a conflict of interest, which is discussed in subchapter 1.4.

For members of the company's executive organ, it should also be a breach of the duty of good faith to knowingly (zavedomo znaya) provide false, incomplete, or misleading information to the board of directors. See discussion in subchapter 1.6.

Duty of disclosure

We recommend establishing an affirmative duty of disclosure for managers and directors. This duty would include: (i) providing full disclosure of any situations which may involve a conflict of interest; and (ii) providing full disclosure to shareholders of any information which is important for the shareholders to have, connected with a decision that is proposed for adoption by a general shareholder meeting. While we are not sure what level of detail should be included in the law, these are the areas which we believe should be covered by such a duty of disclosure:

- disclosure to the company of any direct or indirect interest that a director or manager, and his affiliated persons, has which may conflict with the interests of the company, including a significant ownership interest in another company;
- disclosure to the company of any transactions or proposed transactions, directly or indirectly involving the company or any of its subsidiaries or dependent companies, in which the director or manager, or his affiliated persons, has a conflict of interests, in advance of completion of the transaction;
- disclosure to the shareholders of any significant completed transactions, directly or indirectly involving the company or any of its subsidiaries or dependent companies, in which the director or manager, or his affiliated persons, has a conflict of interests, including the nature of the conflict; and
- disclosure to the shareholders, in connection with a matter brought for decision to a general shareholder meeting, of information known to the directors that a reasonable shareholder would be likely to consider to be important in deciding how to vote, including information about any direct or indirect conflicts of interests that the directors, managers, or controlling shareholder have with respect to the decision.

In addition to these affirmative obligations to provide disclosure, directors and company officials who are responsible for the company's disclosures to the public, including financial reports and press releases, should be under a duty to exercise reasonable care to ensure that the disclosures do not contain important misstatements or omissions.

Application of duties to senior managers who are not members of management organs

Practice is mixed in other countries on whether the duties of directors, established in the law, also apply to senior managers. In most countries, these duties apply only to members of a formal management organ, such as a management board. In common law countries, these duties generally also apply to "officers", who are the persons who hold the most senior positions within the company. In cases of doubt as to whether someone is an officer, the court has discretion to decide this question.

For a Russian company which has a collegial executive organ, the current rules are fine. However, there is a risk that companies may seek to reduce the liability risk of senior managers by choosing to have an individual executive organ rather than a collegial executive organ. For a company with an individual executive organ, only this person can be liable for breach of duty to the company. If this risk of evasion becomes a practical problem in Russia, it could be addressed by requiring that a public company have a collegial executive organ. We do not make a recommendation on this question, because we are not persuaded that this issue is a serious one at the present time. In particular, many public companies already have a collegial executive organ.

See also Chapter 5, in which we recommend that the duties that apply to a company's management organs should also apply to an external manager, to the members of the board of directors of a managing organization, to the senior officials of a managing organization who adopt decisions on behalf of a company, and to a *de facto* director who in practice adopts decisions on behalf of a company without an official position as a director or member of the company's executive organ.

Extension of duty of good faith to controlling shareholders

We recommend extending the duty of good faith to a controlling shareholder, with regard to transactions in which the controlling shareholder, or his affiliated persons, engages directly or indirectly in a transaction with the company. The controlling shareholder would satisfy this duty in much the same way as a director or manager would satisfy it, by ensuring that the conflict is disclosed in advance to the company and the transaction has been approved by non-conflicted members of the board of directors, is fair to the company, and has been approved in compliance with JSC Law chapter 11, if this chapter is applicable.

Because of the special risk that a controlling shareholder will influence the decision by the board of directors to approve a transaction for which he has a conflict of interest, we recommend requiring that the controlling shareholder provide to the company the significant information that the company's board of directors should have to adopt an informed decision. We also recommend requiring that the controlling shareholder should not, directly or indirectly, put pressure on the company's directors or managers in order to obtain their approval of the transaction.

Subchapter 1.3. Should there be a presumption of reasonableness and good faith

Issue: Should there be a presumption of good faith conduct by managers and directors, which must be overcome to find liability?

Russian context

As discussed in subchapter 1.1, it is a general principle of civil law that all participants in civil transactions are obligated to act reasonably and in good faith. According to Civil Code art. 10(3), "participants in civil relations are presumed to exhibit reasonable conduct and good faith" in cases where their rights depend on whether their actions reflect reasonableness and good faith. This presumption can be rebutted, but the plaintiff has the burden of rebutting it.

This presumption is consistent with general rules of civil procedure. Civil Code art. 53 and JSC Law art. 71 establish the duty of governing entities to act reasonably and in good faith. When bringing a suit against these persons, plaintiffs must follow a general procedural provision whereby a plaintiff must prove any statements he makes. Thus, plaintiffs must show that the defendants violated this obligation—in other words, that they acted without reasonableness or without good faith.

Canada

One purpose of this question may be to elicit discussion of the version of the business judgment rule that prevails in the United States, where if directors act without a conflict of interest, there is a presumption that they have acted on an informed basis and in good faith. Canadian courts, like their English counterparts, traditionally refrained from articulating or applying a specific business judgment rule. They did, however, proclaim their reluctance to find a director had breached the duty of care simply because a business decision went badly wrong.[73]

The Supreme Court of Canada appeared to depart radically from past practice when it ruled in 2004 that Canadian courts should apply a "business judgment rule" when assessing whether there has been a breach of duty by directors.[74] The Canadian version of the business judgment rule differs, however, from its U.S. counterpart. The Canadian business judgment rule does not include an explicit presumption of good faith, as such. Instead, it applies only to transactions not involving a conflict of interest, for which the issue to be decided is typically whether the directors have met their duty of care, diligence, and skill, rather than whether they have met their duty of honesty and good faith.

When a decision by the board of directors is challenged, a Canadian court will scrutinize both the process leading up to the decision and the decision itself in assessing whether the directors made a reasonable decision. If the decision falls within a range of reasonableness, the court will not substitute its opinion for that of the board even though subsequent events may have cast doubt on the wisdom of the board's decision.

This contrasts with the United States approach, in which, if the process is satisfactory, the court will in theory not review the decision itself at all. However, there may be less difference in practice between the two approaches than there is in theory, because in practice, courts in the United States, if they are seriously concerned with the merits of a board decision, are more likely to find fault with the process that leads up to the decision.

The Canadian version of the business judgment rule does not affect the analysis where a plaintiff is alleging that a company's directors breached their duty to act in the company's best interests since directors who lack honesty or good faith cannot invoke its protection.

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73 COMMERCE CLEARING HOUSE, CANADA CORPORATIONS LAW REPORTER ¶ 6050.

74 Peoples Dept Stores v. Wise [2004] 3 S.C.R. 461, 491-92 (Can).

Nevertheless, in cases of this sort the courts will generally presume the directors acted in good faith, and it will be up to the plaintiff to produce evidence that the directors did not act in good faith.[75]

The specifics of Canadian law aside, there will be universal agreement that, in a situation in which the directors have a personal interest in a transaction, or have a conflict of interest for another reason, they should not benefit from a presumption that they have acted in good faith. If anything, in this situation, there should be a presumption that the directors have not acted in good faith, and it should be up to the directors to show that they have acted properly. The question of a presumption of good faith conduct therefore arises only in a situation in which the directors do not have either a personal interest or another source of a conflict of interest.

France

There is no "business judgment rule" as a distinct legal concept, that would limit the circumstances in which a court will find liability based on a breach of Code de Commerce art. L. 225-251 for tortious or negligent acts of management. Yet, if one examines actual court decisions, it becomes clear that when only negligence is involved, and not self-dealing, a minor degree of negligence is unlikely to result in liability.

Mere business decisions not involving disloyalty will only result in liability if they are manifestly absurd,[76] for example, providing a loan under circumstances where it was certain that it would not be repaid,[77] or in the case of an insistence to pursue a sale at a loss.[78] More generally, there are said to be limits because of an implicit business judgement rule (*droit à l'erreur*), reluctance to second guess corporate decision making , and discretion in ascertaining negligence.[79]

Germany and Austria

Duty of diligence

The German law on joint stock companies states the directors' duty of diligence in AktG § 93 I 1, and then continues in § 93 I 2:

75 *See* MARKUS KOEHNEN, OPPRESSION AND RELATED REMEDIES 229 (2004).

76 *See* TERRE ET AL., LE DIRIGEANT DE SOCIETE: RISQUES & RESPONSABILITES ¶ 061-11 (2002) (discussing strategic errors). Compare YVES GUYON, DROIT DES AFFAIRES ¶ 459 (11th ed. 2001) (incurring regular business risks will not result in liability; liability can be found only if the decision would be considered unreasonable at the time when it was made).

77 C.A. Paris, Feb. 4, 1994, Rev. soc. 1994, at 136.

78 C.A. Lyon, 1re ch., July 5, 1984, Juris Data no. 1984-041205.

79 Youssef Djehane, *Responsabilité des organes de la société et de surveillance en Europe: réflexions issues détudes de cas relatifs a la responsabilité des organes exécutifs en France*, 124 ZEITSCHRIFT FÜR SCHWEIZERISCHES RECHT 523 (2005).

> There is no violation of this duty when the member, when taking a business decision, could reasonably be presumed to be acting for the benefit of the company on the basis of adequate information.

The provision was meant to codify existing law.[80] It follows the opinion of the Federal Supreme Court (*BGH*) in the ARAG/Garmenbeck case.[81] Uwe Hüffer suggests, in his treatise on the Aktiengesetz, that the provision does not merely shift the burden of proof to the plaintiff if its conditions are met, but creates a completely safe harbor.[82] There have not yet been any court decisions interpreting the scope of this new provision.

AktG § 93 II separately provides that, if there is a dispute over whether a director has met the standard of a "diligent and conscientious manager", the burden of proof is on the director. This provision appears to place the burden of proving proper conduct on the director, and to be in conflict with the "business judgment rule" introduced in AktG § 93 I 2.

Uwe Hüffer suggests that the two provisions can be reconciled as follows. The plaintiff has the burden of proof with respect to the director's conduct, damages incurred, and the causal link between the director's conduct and the damages. The defendant then needs to prove the elements of the business judgment rule, but is relieved from any claims if he succeeds in doing so.[83] That is, the director must show that he reasonably *believed* he was acting in the interests of the company on the basis of adequate information. If the director shows that this belief was reasonable, it will not matter whether the belief was objectively correct.

Duty of diligence in Austria

Austrian law corresponds to German law before 2005. Thus, there is no explicit statutory statement of a business judgement rule and, once the plaintiff has shown the director's conduct, harm to the company, and causation, the director has the burden of proving that he met the statutory standard of diligence . However, it is still recognized that wide discretion should be accorded to managers when they make business decisions without a conflict of interest.[84]

Duty of good faith

As discussed in subchapter 1.2, the German and Austrian AktGs do not contain an express obligation of good faith. The courts have established such an obligation through decisions. These decisions do not address the question of presumptions or burden of proof for breach of the duty of good faith. Under general principles of civil procedure,

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80 UMAG, Sept. 22, 2005, BGBl I at 2802 (F.R.G.).

81 BGHZ 135, 244. *See also* Erich Schanze, *Directors Duties in Germany*, 3 COMPANY AND FINANCIAL INSOLVENCY LAW REVIEW 286, 291 (1999) (discussing this case).

82 UWE HÜFFER, AKTIENGESETZ § 93, ¶ 4c (7th edition 2006).

83 *Id.* ¶¶ 16, 16a.

84 *See,* for example, OGH 1 Ob 144/01k; 8 Ob 262/02s;. *See also* Susanne Kalss, *in* 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 84, ¶ 200 (Bruno Kropff and Johannes Semler editors, 2nd edition 2004).

one may assume in both countries that the plaintiff has the burden of showing lack of good faith.

Korea

This question is hard to answer from the Korean perspectives. “Good faith” is not a well-defined legal term in Korean corporate law. However, any judge in Korea would agree that a presumption of good faith is appropriate in a case that does not involve self-dealing.

In the highly-publicized *Samsung Electronics* case (2001-2005), the courts discussed the directors’ fiduciary duties and whether they had exercised business judgment. In that case, a transaction between two affiliated companies, within the Samsung group, resulted in the transfer of value from a profitable company to a less successful company. There was a shareholder suit against the directors of the profitable company, which was based on negligence, rather than on a claim of self-dealing, because the directors of the profitable company did not directly gain from the transaction.

The trial court focused its discussion on the directors’ duty of care and whether they were negligent. The Seoul High Court also stated that this was not a case of self-dealing, and then ruled in favor of the defendant, on the grounds that they had exercised business judgment and their decision should therefore be protected by what can be seen as a business judgment rule. Therefore, the directors were not required to show that they have acted in good faith. Instead, they were, in effect, presumed to have done so.

United Kingdom

In England, there is a general assumption that persons have acted in good faith. Anyone who alleges bad faith must state and prove this claim and do both clearly. This presumption is not limited to company law. It can be seen most easily from the English rules of civil procedure, which address the question of pleading and proving conscious bad faith (and cognate concepts such as fraud).[85] The effect of these rules is that bad faith must be specifically pleaded, and at trial the claim of bad faith must be supported by evidence: it is not to be assumed.

Aside from the general presumption of good faith, the United Kingdom does not have a United States style business judgment rule.

United States

Business Judgment Rule

As a general rule, American courts do not hold directors liable for business decisions, made without a conflict of interest, unless those decisions are completely irrational. This doctrine of judicial non-interference is known as the *business judgment rule*. The

85 *See* Civil Procedure Rules, Practice Direction 16, ¶ 8(2), as supplemented by strict professional guidance to advocates in the Code of Conduct of the Bar of England and Wales §704(c) (2004).

business judgment rule involves a presumption that the directors have acted on an informed basis, in good faith, and in the interests of the corporation. The plaintiff must rebut one or more of these presumptions.

In cases involving a conflict of interest, it will often be straightforward to overcome the presumption of good faith. If a conflict of interest cannot be shown, then it will be rare for the plaintiff to be able to rebut the presumption of good faith. If the plaintiff cannot rebut the presumption of good faith, the plaintiff is left with the difficult challenge of showing that the directors have not acted on an informed basis, and overcoming the presumption that they have acted on an informed basis. If the plaintiff cannot rebut the presumption that the directors have acted on an informed basis, the plaintiff will lose the case. The courts will not review the merits of the decision they made. The business judgment rule, *not* the ordinary negligence standard, sets the standard by which breach of the duty of care is measured.[86]

The business judgment rule has several justifications. First, judges are usually not businesspeople. They are bad at second-guessing decisions that turned out poorly, and deciding whether they were poor decisions when made. Business decisions are often made quickly, based on highly incomplete information. Yet, the delay to gather better information may be as costly as the mistakes from proceeding without the information. With the benefit of hindsight, a complaining shareholder can point out how much the directors could have known but did not know when deciding, or how rushed their decision was. A decision that was reasonable when made may seem unreasonable in hindsight.

Second, an investment in a company's shares can turn out badly for many reasons, of which bad management decisions are only one. The risk of bad decisions, like the other sources of bad outcomes, is a risk that shareholders knowingly assume. Moreover, this is a risk that shareholders can reasonably assume because the directors' and shareholders' interests largely coincide.

This is a critical distinction between ordinary decisions, where directors and shareholders have a common interest in seeing the business prosper, and self-dealing transactions, where insider and shareholder interests are opposed. It is considered to be reasonable to ask shareholders to assume the risk of a bad outcome if the directors' and shareholders' incentives coincide. In contrast, U.S. rules are much stricter in situations in which the directors have a personal interest in a transaction, and can potentially gain at the shareholders' expense, because there are too many scenarios in which the insiders will succumb to the moral hazard created by diverging incentives.

Third, some risky decisions will work out wonderfully, while others will work out terribly. If the directors -- who are and should be modestly paid, because high pay could compromise their independence -- face a risk of personal liability for a bad outcome, they will be reluctant to take risks generally. They may make fewer bad risky decisions, but

86 The classic explanation for the business judgment rule as a doctrine of judicial abstention is offered by Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics and Tender Offers*, 33 STANFORD LAW REVIEW 819, 823 (1981).

they will also make fewer good risky decisions. We may not get better decisions on average, just more cautious decisions.

The business judgment rule can be accepted more easily if we recognize that there are multiple constraints that lead most company managers, most of the time, to work hard at their jobs -- including product market competition; the market for corporate control; the managerial labor market; incentive compensation; managerial culture; and the statement in the company law (in the duty of care) that directors are supposed to try hard, directed at responsible adults who try to do their jobs. It can make sense for judges not to second-guess even decisions that the judges think are terrible, as long as these other constraints encourage managers to do the best job they can, especially because second-guessing of decisions by the courts could chill risk taking.

The case for judicial abstention is even stronger in civil law countries such as Russia, where judges often have no practical experience. This can only make them worse than American judges, who often were practising lawyers before becoming judges, at deciding whether business decisions were reasonable. Even the judges of the Delaware Chancery Court judges, who hear a steady stream of business cases and are usually chosen from among leading business lawyers in Delaware, feel that they are ill-equipped to evaluate the merits of business decisions. Judges who lack this experience can only be worse at this difficult task.

Summary and recommendations

The table below summarizes the extent to which the comparison countries apply a presumption of good faith in evaluating directors' compliance with their duties to the company. With some oversimplification, we treat the common law duty of care as comparable to the Russian Civil Code requirement of reasonableness and to the rules in some countries that establish liability of directors for negligence. We also treat the common law duty of loyalty as comparable to the Russian Civil Code requirement of good faith, and to the concept that a director must act in the interests of the company, when these conflict with his personal interests.

Overview of Presumptions for Duties of Directors

Country	Presumption of Good Faith for Duty of Care and Reasonableness Claims	Business Judgment Rule Applies if No Conflict of Interest	Presumption of Good Faith for Transactions Involving Conflict of Interest
Russia		No	
Austria		In practice, but no formal doctrine	
Canada	X	Probably	X (would likely follow U.K. precedent)
France		In practice, but no formal doctrine	
Germany		X	
Korea	X	Implied	
United Kingdom	X	No	X
United States	X	X	Presumption reversed: defendant must show entire fairness

As the table indicates, several countries apply a presumption of good faith for director conduct that does not involve a conflict of interest, but other countries do not do so. In practice, most countries give deference to the decisions adopted by the board of directors, if made without a conflict of interest. In some cases, this deference is formalized in the form of a business judgment rule; in other countries it can be implied from court practice. Only the U.K. (and likely Canada, by following U.K. precedent) extends the presumption of good faith to transactions involving a conflict of interest.

Presumption of reasonableness and good faith, if no conflict exists

We recommend that directors should benefit from a presumption of reasonableness, such as the presumption reflected in the U.S. version of the business judgment rule, if (i) the directors act without a conflict of interest, and (ii) the transaction does not involve a conflict of interest on the part of another director or member of management, or the company's controlling shareholder. This, however, raises the question of how the court is to decide whether a transaction involves such a conflict.

We recommend that the presumption of reasonableness should apply unless the plaintiff can produce evidence which gives the court some grounds for considering that a conflict of interest may exist. If the plaintiff can present this evidence, the burden of proof should then be on the defendants, who are in the best position to produce this information, to show that there is, in fact, no conflict of interest. If (i) the plaintiff fails to provide evidence suggesting that a conflict of interest may exist, or (ii) the plaintiff provides this evidence, but the defendant proves that there is no conflict of interest in fact, then the presumption of reasonableness should apply to the decision which has been challenged.

We recommend that there should also be a presumption of good faith, for a transaction in which there is no evidence that a conflict of interest may exist. The presumption of good faith is a general aspect of Russian civil law. We do not recommend any change in this overall presumption. Instead, we discuss below the circumstances under which this presumption can be considered to have been rebutted.

No presumption of reasonableness or good faith, if a conflict may exist

If there is evidence, which the defendants have been unable to successfully rebut, of a conflict of interest on the part of the directors who adopted a decision, other directors or members of management, or a controlling shareholder, we recommend that there should be no presumption of reasonableness. We also recommend that this evidence should be sufficient to rebut the general civil law presumption of good faith.

With regard to a transaction for which a conflict of interest may exist, one needs to consider separately the following situations:

- a director does not have a personal conflict of interest, but adopts a decision to approve a transaction for which another director or a senior manager has a conflict of interest;
- a director does not have a personal conflict of interest, but adopts a decision to approve a transaction for which a controlling shareholder has a conflict of interests; and
- a director has or may have a personal conflict of interest.

In the first situation, we recommend that there should be no presumption one way or the other as to the reasonableness of the director's decision or the good faith of this decision. In the second situation, involving a transaction in which a controlling shareholder has a conflict of interest, even apparently non-interested directors potentially face a conflict of interest due to desire to retain their positions (see subchapter 1.5). To provide additional protection for outside shareholders against self-dealing by controlling shareholders, we recommend that non-interested directors have the burden of proof to show that their approval of a transaction, for which a controlling shareholder has a conflict of interest, was made after full disclosure of the conflict and was reasonable in substance. This showing should be considered to satisfy both the duty of reasonableness and the duty of good faith.

In the third situation, where a director has or may have a personal conflict of interest, the question of breach of duty centrally concerns not the duty of reasonableness, but instead the duty of good faith.

Presumption of lack of good faith, if a conflict may exist

If the plaintiff provides evidence that a director or a controlling shareholder has a conflict of interest with respect to a transaction involving the company or a subsidiary or dependent company, we recommend that the director or controlling shareholder should be presumed to have *not* acted in good faith. That is, the showing by the plaintiff of a personal conflict of interest should not merely remove the usual civil law presumption of good faith, it should also be sufficient to shift the presumption the other way.

A director can rebut this presumption of lack of good faith in two ways. First, the director can prove that, in fact, he had no conflict of interest. Second, a director who has a conflict of interest is required to prove that he satisfied the requirements of the duty of good faith. We discuss these requirements in subchapter 1.3.

We believe that it is appropriate to place the burden of proof on the defendant for several reasons. First, it is important for the JSC Law to discourage conflict-of-interest transactions. Second, the evidence concerning the existence of a conflict, and the fairness of the transaction, is often not available to a plaintiff, and should be much more readily available to a defendant. Third, imposing a strict burden of proof will provide an incentive for directors and managers, who are considering completing a transaction as to which a conflict of interest may exist, to ensure that the transaction is approved in accordance with JSC Law chapter 11. Compliance with the procedures established in chapter 11, in turn, will reduce the risk that the company will complete a transaction that favors a director, manager, or controlling shareholder, at the expense of the company.

On when a conflict of interest should be considered to exist, see subchapter 1.4. On the rules governing controlling shareholders, see subchapter 1.5.

Subchapter 1.4 Concept of self-interest

How should the law define the concept of self interest in completing a transaction by a company? What should be considered to be a conflict of interest?

General comments

For the most part, we focus on the substantive regulation of conflict-of-interest transactions, and not on the rules governing disclosure of these transactions. Disclosure rules exist under securities law for public companies, under stock exchange listing rules for public companies, and under accounting rules. In particular, both International Financial Reporting Standards and United States Generally Accepted Accounting Principles call for disclosure of conflict-of-interest transactions.

Transactions in which a director, senior manager, or major shareholder has a direct or indirect financial or other interest are given several names. They can be called "related party transactions," "self-interested transactions," "self-dealing transactions," or "conflict-of-interest transactions." We use the term "conflict-of-interest transactions."[87]

This subchapter addresses the rules applicable to a transaction in which a director or manager has an interest. We address in the next subchapter the special case of transactions in which a controlling shareholder has an interest.

87 For a general overview of the approaches used in different countries to control self-dealing, see Luca Enriques, *The Law on Company Director Self-Dealing: A Comparative Analysis*, 2 INTERNATIONAL AND COMPARATIVE CORPORATE LAW JOURNAL 297 (2000).

Russian context

Defining a Transaction Involving a Self-Interest

The concept of individual interest exists solely within the framework of rules pertaining to particular types of transactions which require special approval procedures under the JSC Law. Russian does not include a word or phrase which directly translates as self-interest. The JSC Law therefore essentially invents a new term хаинтерованность, which has the sense of a personal interest. We will translate this term as "self-interest." JSC Law art. 81 defines a transaction as one involving a self-interest, if it is entered into by one of the following persons:

- a member of the company's board of directors (supervisory board) or collegial executive organ;
- the general director or the managing organization;
- a shareholder of a company who possesses, together with affiliates, 20% or more of the company's common shares; or
- persons who have the right to give the company instructions which are binding for that company.

Some scholars are of the opinion that shareholders should not be included in this list because the purpose of the conflict-of-interest rules is to prevent abuse of power by members of a company's management organs, and shareholders are not members of these organs.[88] The inclusion of the concept of an affiliate significantly broadens the scope of interested persons, and can complicate the determination of whether a transaction involves a self-interest.[89] Persons who may potentially have the right to give a company binding instructions are:

- a parent company in relation to a subsidiary company (Civil Code art. 105, JSC Law art. 6);
- a predominant company in relation to a dependent company (Civil Code art. 106);
- members of a company's liquidation commission and the insolvency officer for an insolvent company (Insolvency Law art. 24).

Under JSC Law art. 81, these persons shall be deemed to have a self-interest in the completion of a transaction by the company if they or their spouses, parents, children, full and half-brothers and -sisters, adoptive parents and adopted children and/or their affiliates:

88 A. Novozhilov, *Transactions Involving Individual Interest in Joint-Stock Legislation* (2001) (А. Новожилов, *Сделки с заинтересованностью в акционерном законодательстве*), at www.lprava.ru/ru/publications/01.htm.

89 Law No. 948-1 of the RSFSR "On Competition and the Restriction of Monopolistic Activity on the Market" (Mar. 22, 1991, as amended) (Закон РСФСР от 22.03.1991 № 948-1 «О конкуренции и ограничении монополистической деятельности на товарных рынках», с изменениями) defines affiliates as physical and legal entities capable of influencing the activity of other legal and/or physical entities involved in entrepreneurial activities.

- are a party, beneficiary, intermediary or representative in the transaction;
- possess (individually or in the aggregate) 20% or more of the shares in a legal entity which is a party, beneficiary, intermediary or representative in the transaction;
- hold posts in the management organs of a legal entity which is a party, beneficiary, intermediary or representative in the transaction, or in the management organs of a managing organization of such legal entity; or
- in other instances specified by the company's charter.

Under the JSC Law, transactions involving a self-interest should be (a) approved following a defined procedure. Failure to comply with the procedure will (b) invalidate the transactions, and, (c) if the company incurs losses as a result of the transaction, the self-interested persons can be held liable. We will consider each step separately.

The Procedure for the Approval of a Self-Interested Transaction

The procedure for approval of a self-interested transaction depends on the number of shareholders of the company and the amount of assets involved in the transaction. If the company has 1000 or fewer shareholders, the decision on approval of the transaction must be adopted by the board of directors by a majority of votes of directors who do not have a self-interest in the transaction. If the company has more than 1000 shareholders, the decision on approval of the transaction must be adopted by the board of directors by a majority of votes of the *independent* directors who do not have a self-interest in the transaction.[90] The JSC Law does not indicate the number of independent directors necessary to have authority to approve a self-interested transaction. Thus, a decision to approve a self-interested transaction can be adopted by even a single independent director if all other independent directors are interested persons.

In some cases, a transaction must also be approved by a general shareholder meeting, by majority vote of non-interested shareholders. For example, shareholder approval is required if the value of the assets which are the subject of the transaction (or a number of interrelated transactions) equal 2% or more of the balance sheet value of the company's assets. Unfortunately, the law does not include criteria for determining when transactions are interrelated. In addressing this question, the courts have focused on the following attributes:

- *Transaction Participants*. Courts have repeatedly come to the conclusion that, in cases where the "factual owner" of the assets in one transaction and the parties to another transaction are the same, the transactions are considered interrelated.[91]

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90 We discuss the concept of an independent director in Chapter 2.

91 *See* Decision of the Federal Arbitrazh Court of the Central District No. A54-2564/03-S17-S19 (Dec. 3, 2004) (Постановление Федерального арбитражного суда Центрального Округа от 03.12.2004, № A54-2564/03-C17-C19); Decision of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No. 1720/02 (Aug. 27, 2002) (Постановление Президиума Высшего Арбитражного Суда Российской Федерации от 27.08.2002, № 1720/02); Decision of the Federal Arbitrazh Court of the Volgo-Vyatskiy District No. A28-7021/2003-201/22 (March 19, 2004) (Постановление Федерального Арбитражного Суда Волго-Вятского Округа от 19.03.2004, № A28-7021/2003-201/22).

- *Purpose of Entering into a Transaction*. If the transactions have a unified economic purpose, then they are deemed interrelated.[92]
- *Time of the Conclusion of the Transactions*. The conclusion of the transactions at similar (different) times is evidence of interrelatedness (lack of interrelatedness) between transactions.[93]
- *Unified Purpose for the Subject of the Transactions*. If the assets which are the subject of two or more transactions have a unified purpose (for example, their use in the same or related economic activities), this is evidence of interrelatedness of the transactions.[94]
- *Types of Transactions*. The fact that transactions vary in their legal nature allows the courts to consider them not interrelated.

Liability of interested persons and members of company management organs for noncompliance with the requirements for approval of a self-interested transaction

When a company incurs losses through a transaction involving individual interest, the liability of the interested person shall be determined by JSC Law 84(2).[95] There is a general Civil Code rule that liability requires the existence of fault (Civil Code art. 401). Therefore, some scholars have argued that liability for improper approval of a self-interested transaction should also require fault.[96] It is also essential to show causation between the losses and the actions of the interested person. In practice, proving such a link is extremely complicated.

The question of which persons have the right to file a claim for the recovery of losses from the interested person remains unresolved. Some scholars contend that both the

92 *See* Decision of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No. 10030/03 (Oct. 21, 2003) (Постановление Президиума Высшего Арбитражного Суда Российской Федерации от 21.10.2003, № 10030/03); Decision of the Federal Arbitrazh Court of the Central District No. 48-3333/02-10 (Sept. 8, 2003). (Постановление Федерального Арбитражного Суда Центрального Округа от 08.09.2003, № 48-3335/02-10)

93 *See* Decision of the Federal Arbitrazh Court of the Moscow District No. KG-A40/8643-02 (Jan. 14, 2003) (Постановление Федерального Арбитражного Суда Московского Округа от 14.01.2003, № КГ-А40/8643-02); Decision of the Federal Arbitrazh Court of the Volgo-Vyatskiy District No. A28-7021/2003-201/22 (March 19, 2004) (Постановление Федерального Арбитражного Суда Волго-Вятского Округа от 19.03.2004, № А28-7021/2003-201/22).

94 *See* Decision of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No. 7291/02 (Jan. 28, 2003), (Постановление Президиума Высшего Арбитражного Суда РФ от 28.01.2003, № 7291/02); Decision of the Federal Arbitrazh Court of the North-Western District No. A56-34162/02 (Aug 13, 2004), (Постановление Федерального Арбитражного Суда Северо-Западного Автономного Округа от 13.08.2004, № А56-34162/02).

95 We discuss the concept of losses in subchapter 2.7.

96 M. V. Telyukina *The Approval of Transactions Involving Individual Interest*, 3 ARBITRAZH PRACTICE (2005a) (М.В. Телюкина *Одобрение заинтересованных сделок*, АРБИТРАЖНАЯ ПРАКТИКА).

shareholder and the company itself have this right, while others argue that the company alone has this right.[97]

Treating a Transaction as Invalid Due to Noncompliance with Approval Procedure

Under JSC Law art. 84, a self-interested transaction that is completed without complying with the approval requirements specified in the JSC Law can be invalidated. Invalidation results in restitution -- the return by each of the parties of everything received through the transaction (Civil Code art. 168). The interested person must also compensate the company for losses. Under JSC Law 84(1), the shareholder and the company have the right to file suit to invalidate a self-interested transaction.

The law, however, leaves open several questions. First, it is unclear whether persons who became shareholders after the transaction is completed have the right to file suit. Legal precedent tends to favor of conferring the right to file suit only on persons who were shareholder when the transaction was completed.[98]

Second, the JSC Law does not specify when the statute of limitations on a suit to invalidate a self-interested transaction begins to run -- when the transaction is completed, or when the shareholder or the company learned (or should have learned) that the transaction involved a self-interest? (Civil Code art. 181(2)). Legal precedent indicates that "the statute [of limitations] should begin to run at the point where the shareholder/company learned or had a realistic chance to learn not only of the completion of the transaction itself but also of the fact that it was entered into by persons interested in its conclusion".[99]

Third, is noncompliance with the approval procedure a sufficient basis to invalidate a transaction, or must the company have incurred losses as well? Amendments have been proposed to the JSC Law to allow for invalidation only if the company has incurred losses.[100]

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97 For the former view, see V. P. MOZOLIN AND A. P. YUDENKOV, COMMENTARY ON THE FEDERAL LAW ON JOINT-STOCK COMPANIES (Norma Press, 2003) (В.П. МОЗОЛИН, А.П. ЮДЕНКОВ КОММЕНТАРИЙ К ФЕДЕРАЛЬНОМУ ЗАКОНУ «ОБ АКЦИОНЕРНЫХ ОБЩЕСТВАХ», Издательство Норма). For the later view, see M. V. TELYUKINA, COMMENTARY ON THE FEDERAL LAW ON JOINT-STOCK COMPANIES (Wolters Kluwer Press, 2005b) (М.В ТЕЛЮКИНА КОММЕНТАРИЙ К ФЕДЕРАЛЬНОМУ ЗАКОНУ «ОБ АКЦИОНЕРНЫХ ОБЩЕСТВАХ» (ПОСТАТЕЙНЫЙ) (Волтерс Клувер).

98 *See,* Decision of the Plenum of the Supreme Arbitrazh Court of the Russian Federation No. 19 "On Some Questions of the Application of the Joint Stock Company Law" point 36 (Nov. 18, 2003) (Постановление Пленума Высшего Арбитражного Суда Российской Федерации от 18.11.2003, № 19 «О некоторых вопросах применения Федерального закона «Об акционерных обществах», пункт 36); Decision of the Federal Arbitrazh Court of the Volga District No A57-3548/03-15 (Sept. 18, 2003) (Постановление Федерального Арбитражного Суда Поволжского Округа от 18 сентября 2003 года, N A57-3548/03-15).

99 Decision of the Constitutional Court of the Russian Federation "On the case of the examination of the constitutionality of Joint Stock Company Law 84(1)" (Apr.10, 2003) (Постановление Конституционного Суда Российской Федерации от 10 апреля 2003 года по делу о проверке конституционности пункта 1 статьи 84 Федерального закона «Об акционерных обществах»).

100 See Outline of the Development of Corporative Legislation for 2008 prepared by the National Council on Corporate Management («Концепция развития корпоративного законодательства на 2008 год», подготовленная Национальным Советом по Корпоративному Управлению) and Draft Federal

Transactions involving a self-interest, as defined in JSC Law arts. 81-84, are part of the more general concept of “conflict of interest”.[101] In our view, many of the legislative shortcomings indicated above became possible due to the insufficient development of the general notion of “conflict of interest” in Russian law.

Canada

In Canada, there are conflict-of-interest rules specifically directed to situations where a director or officer engages, directly or indirectly, in a transaction with his or her company. There are no rules directed to the situation where dominant shareholder, who is not a director, has done so. Under Canadian law, dominant shareholders do not owe any fiduciary duties to minority shareholders. In practice, however, if a dominant shareholder carries out conflict-of-interest transactions which are prejudicial to the interests of the company or the minority shareholders, minority shareholders should be able to obtain relief under the oppression remedy provided by Canadian corporate legislation.

Under the judge-developed common law, contracts where the director of a company was a party to a contract with the company were voidable at the company’s option, whether or not the transaction was fair to the corporation. The CBCA and other Canadian statutes adopt a more permissive approach, and permit certain transactions between a director or officer and the corporation, provided that procedural safeguards are observed, which are intended to make it more likely that the transaction is fair to the company.[102] Under CBCA § 120, if a director or officer is a party to, or otherwise has a material interest in, a “material” contract with the corporation, the interested director or officer must give written notice to the corporation of the nature and extent of the interest or have the information entered into the minutes of a directors’ meeting. When notice is given, the contract must be approved by the board of directors or by the shareholders. Directors typically are prohibited from voting on the approval of any contract in which they have an interest. If the contract is disclosed to the board and approved by the remaining directors, the contract is valid despite the director's interest.

With regard to the situation where a director or officer is not directly a party to a contract, but may have an interest in the contract, the term “material interest” is not defined in the legislation and There is no definition of a “material” contract or a "material interest" in a transaction, and there is little case law on point.[103]. The concept of "material interest" will surely cover situations where the party to a contract was a spouse of the director or a family member, or where a spouse had a material interest. The courts will likely take a

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Law "On the Introduction of Amendments into Some Laws of the Russian Federation (in the area of corporate conflict resolution improvement)" (Draft No. 384664-4) (Законопроект «О внесении изменений в некоторые законодательные акты Российской Федерации (в части совершенствования разрешения корпоративных конфликтов)» (Проект N 384664-4)).

101 We discuss the concept of conflict of interest further in subchapter 3.4.

102 J. ANTHONY VANDUZER, THE LAW OF PARTNERSHIPS AND CORPORATIONS 275 (2nd edition 2003).

103 *Id.*

broad approach in determining whether there is a material interest, and will not require the interest to be purely financial.[104]

A less clear situation is where a director owns shares in the corporation which is the party on the other side of the contract. Academic commentators have argued that in this situation the contract, and the director's ownership interest, taken together, must be of sufficient size so that completion of the contract would have a significant effect on the value of the director's interest in the other corporation. This means, for instance, that if a director owns $1 million in shares in a large widely held bank, the statutory provisions would not govern a loan between the director's corporation and the bank, because the completion of the loan will have little or no effect on the value of the bank's shares.[105]

It is not clear what would happen if a contract is not "material," is not disclosed to or approved by the board, and is later discovered. The court might apply common law rules to the transaction, but there are no cases on point. However, in most cases, if the transaction is in fact small, the failure to disclose it will mean that this failure will have no practical consequences.

European Union

The need for companies to have independent directors, in part so that these directors can be assigned the task of reviewing proposed conflict-of-interest transactions, is addressed in a 2005 Recommendation of the European Commission on the role of non-executive or supervisory directors of public companies and on committees of the board of directors The recommendation calls for public companies to have a "sufficient number" of independent directors "to ensure that any material conflict of interest involving directors will be properly dealt with."[106] The recommendation does not include discussion of the standard of care or the standard of liability, either for independent directors who review a conflict-of-interest transaction, or for the persons who may engage in such a transaction and seek to obtain approval from the independent directors.

New Art. 43(7b) of the Accounting Directive (78/660/EEC)[107] requires firms to disclose information in the notes to their annual financial statements on transactions with related parties. To define a "related party," the Directive refers to International Accounting Standard (IAS) 24.9, which defines this term to include parties that control the firm or have an interest giving them significant influence, associates, joint ventures, key

104 Markus KOEHNEN, OPPRESSION AND RELATED REMEDIES 242-43 (2004).

105 KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 755-756 (1999).

106 See 2005/162/EC.

107 As amended by Directive 2006/46/EC (June 14, 2006) on the annual accounts and consolidated accounts of companies (amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings).

management personnel, close family members of or entities controlled or influenced by such parties, and benefit plans for the employees of the company or a related party.

France (with a note on Latvia)

The rules governing conflict of interest transactions are very similar for companies with one-tier and two-tier boards. Thus, we will address only the more important one-tier system. The Code de Commerce provides for disclosure of conflict-of-interest transactions to the board of directors and approval of these transactions by the board of directors and by the shareholders. The rules cover a transaction that involves the company and, directly or indirectly, a director, general manager, assistant general manager, or 10% shareholder. The interested person cannot participate in voting at either the board level or the shareholder level. If a transaction is not disclosed, it is voidable at the option of the company. More specifically, Articles L. 225-38 et seq. provide:

> Article L. 225-38: Any agreement entered into, either directly or through an intermediary, between the company and its general manager, one of its assistant general managers, one of its directors, one of its shareholders holding a fraction of the voting rights greater than 10% or, in the case of a corporate shareholder, the company which controls it within the meaning of Article L. 233-3, must be subject to the prior consent of the board of directors. The same applies to agreements in which a person referred to in the previous paragraph has an indirect interest. . . .
>
> Article L. 225-39: The provisions of Article L. 225-38 are not applicable to agreements relating to current operations entered into under normal terms and conditions. Such agreements are nevertheless made known to the chairman of the board of directors by the interested party unless they are of no significance to any party, given their objective or their financial implications. A list of such agreements and their objectives is sent to the members of the board of directors and to the auditors by the chairman.
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> Article L. 225-40: The interested party must inform the board immediately upon becoming aware of an agreement to which Article L. 225-38 applies. They may not participate in the vote on the requested prior approval of the Board. The chairman of the board of directors shall advise the auditors of all agreements authorised and shall submit them to the general meeting [of shareholders] for approval. The auditors shall present a special report on the agreements to the meeting, which shall rule on this Report. The interested party may not participate in the vote and their shares shall not be taken into account for the calculation of the quorum and the majority. . . .
>
> Article L. 225-42: Without prejudice to the liability of the interested party, agreements referred to in Article L. 225-38 and entered into without the prior authorisation of the board of directors may be cancelled if they have prejudicial consequences for the company. Nullity proceedings shall be time-barred after three years with effect from the date of the agreement. . . .

There is also a general ban on loans by the company to directors who are natural persons.

> Article L. 225-43: In order for the contract to be valid, directors other than legal personalities shall be prohibited from contracting loans from the company irrespective of their form, from arranging for it to grant them a loan account or other borrowing whatsoever, or to arrange for the company to stand surety for them or act as their guarantor in respect of their obligations to third parties.(…)

From these provisions follows that some transactions are always prohibited (art. L. 225-43), minor transactions are not subject to special regulation, (art. L. 225-39), and that the remaining transactions require authorisation by the board of directors and approval by the general meeting of shareholders (arts. L. 225-38, 225-40).

The concept of an indirect interest in a transaction is not defined in the law. Opinions in decided cases provide some guidance on the scope of this concept. For instance, there is an indirect interest where a director is also the dominant shareholder of the counterparty of the transaction,[108] or where the CEO of one company is also the CEO of the counterparty to the transaction.[109] However, one case finds that there was no indirect interest where the company engaged in business with another company established by the children of the CEO.[110] In our view, this case is problematic, because the involvement in the transaction of close relatives of the CEO or a member of the board of directors should be regarded as creating an indirect interest on the part of the CEO or board member.[111]

Germany

In ordinary transactions, the management board represents the company in contractual transactions and can bind it with respect to third parties. However, AktG § 112 states that the supervisory board represents the company in its dealings with members of the management board, both inside and outside of court.

This provision addresses only direct dealings between the company and a management director. It does not extend to an indirect interest, as would be involved for a contract with family members of a management director or other parties in which the management director has an interest. However, as a practical matter, a management director may find it advisable to request supervisory board approval in these situations.

In a transaction involving the company and a member of the supervisory board, the company will be represented by the management board, which is the general rule. This will also be the case for transactions in which a supervisory board member has an indirect interest. At the same time, in practice, there may be some reluctance on the part of the management board to disapprove a transaction proposed by a member of the supervisory board.

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108 *See* Cass. com., Oct. 4, 1988, Bull. Joly, No. 681

109 Paris, June 26, 1990, Dr. sociétés, No. 269

110 Cass. com., Oct. 23, 1990, Bull. civ. IV, No. 254

111 *Cf.* Latvian Commercial Code § 309(3): If there is a conflict of interest between the company and a member of the board of directors, his or her spouse, kin or in-laws, counting kinship up to the second degree and affinity up to the first degree, the issue shall be decided at a board of directors meeting, in which the interested member of the board of directors shall not have voting rights.

AktG § 89 requires supervisory board approval for loans extended by the firm to members of the management board if the amount of the loan exceeds the debtor's monthly salary. The resolution must specify the terms of the loan and must be passed no more than three months before the loan is made. There are similar provisions for loans to other senior company officials who have the power to bind the company in its dealings with third parties (AktG § 89 II), members of the supervisory board (AktG § 115 I), and spouses, partners, underage children and persons acting for the account of a management director, supervisory director, or other senior official (AktG § 89 III and § 115 II).

Korea

The concept of conflict of interest is not well defined in the KCC. Scholars believe that Korea still needs to develop a comprehensive approval and disclosure requirement for related party transactions.

Under KCC art. 398, a director may effectuate a transaction with the company for his own account or for account of a related person only with the approval of the board. Under KCC art. 391, a director who has a special interest in a transaction may not vote on the approval of the transaction. If this approval is not obtained, the transaction is voidable, at the option of the company.

> **Article 398 (Transaction between Director and Company)**
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> A director may effectuate a transaction with the company for his own account or for account of a third person only if he has obtained the approval of the board of directors. In this case, Article 124 of the Civil Code (providing for voidability) shall not apply.

A proposed amendment to Article 398 would extend the class of conflict-of-interest transactions to include transactions involving a director's immediate family members and any companies controlled, directly or indirectly, by the director and his family members. The proposed amendment would also require that a conflict-of-interest transaction must be fair to the company, and would require that board approval must be obtained in advance. At present, there are cases in which the conflict is not disclosed in advance, but the board of directors approves the transaction later on, after it becomes publicly known, in order to protect the company and the director against a lawsuit or adverse publicity.

In May 2000, a group of international consultants noted the weaknesses in Korea's regulation of conflict-of-interest transactions, and recommended that these transactions should be approved by non-interested directors and, for major related party transactions, by non-interested shareholders.[112]

Under KCC art. 397, no director shall effectuate any transactions, which are within the class of businesses engaged in by the company, for his/her own account or for that of a third person, or shall become a director of any other company whose business purposes are similar to those of the company of which he is currently a director.

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112 Bernard Black, Barry Metzger, Timothy OBrien and Young Moo Shin, *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness*, 26 JOURNAL OF CORPORATION LAW 537-609 (2001), at 567-568, *at* http://ssrn.com/abstract=222491.

Article 397 (Prohibition of Competing Business)

(1) No director shall, without the approval of the board of directors, effectuate for his own account or for the account of a third person any transaction which falls within the line of businesses of the company or become a member with unlimited liability or a director of any other company whose business purposes are the same as those of the company.

(2) If any director has effectuated a transaction for his own account in breach of paragraph (1), the company may, by the resolution of the board of directors, deem such transaction as effectuated for account of the company and if he has effectuated a transaction for account of a third person, the company may demand the pertinent director to transfer any gain accrued therefrom.

(3) The rights under paragraph (2) shall be extinct with the lapse of one year after the day on which such transaction has been effectuated.

United Kingdom

The question of what counts as a conflict of interest has been addressed primarily in judicial decisions under the common law, and is not specified in the Companies Act. However, the common law is supplemented by specific legislative rules and, for public companies, by the Listing Rules of the London Stock Exchange.

English courts have deliberately refrained from giving an exhaustive definition of a "conflict of interest", in order to be able to cope with new situations. The concern is that a bright-line rule could be evaded through clever transaction planning. The scope of what could be considered a conflict must be inferred from the cases. The basic concept is that a conflict of interest exists where there is any factor (usually, though not always, a financial factor) which might tempt a director or officer to act to favor that interest, at the company's expense.[113]

Under the common law, a transaction completed in the presence of a conflict of interest is actionable unless it has been authorized. Authorization must be shown and is not assumed. There are a number of ways for a transaction to be authorized. First, a class of transactions can be authorized in general through a provision in the company's charter. See, for example, Table A, Regulations 85-86, 94-98. Authorization can also be provided for a specific transaction by the board of directors or by a general meeting of shareholders for a specific transaction, before the transaction is completed. The board of directors can authorize a conflict-of-interest transaction only if the charter provides that the board has this authority, but most company charters so provide.

For the authorization to be valid, the board or the shareholders must be fully informed about the nature of the transaction and the conflict of interest, and the company must be

113 The theoretical underpinning of the conflict of interest rules is explored in Matthew Conaglen, *The Nature and Function of Fiduciary Loyalty*, 121 LAW QUATERLY REVIEW 452 (2005). This article addresses the rules applicable to fiduciaries in general, not just directors, but it is entirely relevant to company directors and officers.

solvent.[114] Finally, the board (if the charter so provides) or the shareholders can authorize a specific transaction after the transaction is completed, again provided that the board or the shareholders are fully informed and the company is solvent.[115] Sometimes, the term "ratification" is used to refer to authorization of a transaction after it has been completed.

The concepts of authorization and ratification are not limited to conflict-of-interest transactions, but instead apply generally to any conduct by directors or officers, which might be challenged as a breach of their fiduciary or other duty to the company.

These rules change if a company is insolvent or on the verge of insolvency. For an insolvent company, the board and shareholders lose their power to authorize or ratify a conflict-of-interest transaction. If the company is on the verge of insolvency, the courts restrict the ability of shareholders to authorize or ratify a conflict-of-interest transaction, in order to protect creditors.[116] The real interests of such a company are identified with those of creditors, rather than shareholders, because the creditors' claims on the company's assets rank ahead of the shareholders' claims.

Indirect interests are included in the set of interests which trigger the common law rules governing conflicts of interest. Plenty of examples can be found in even the very old cases. Early cases include *Re Cape Breton Co. Ltd.* (1885) 29 Ch.D. 795 (purchase by company of property in which its director had a beneficial interest under a trust, but not full ownership); *Transvaal Lands Co.* v. *New Belgium (Transvaal) Land & Development Co.* [1914] 2 Ch. 488 (director interested in a contract with another company in which he held shares as trustee); *Aberdeen Railway Co.* v. *Blaikie* (1854) 1 Macqueen's House of Lords Appeals 461 (director interested in a contract with a partnership of which he was a member).

The common law rules on conflicts of interest are supplemented (not replaced) by statutory rules which apply to specific types of transaction in which the director has a conflict of interest.[117] One important set of these rules concern "substantial property transactions" between a company and a director or a person associated with a director: (Companies Act 1985 §§ 320-322, 346, replaced by Companies Act 2006, §§ 190, 196, 254-256). Whether a transaction falls within the scope of one of these rules depends on the specific wording of the statute. The statute drafters did not try to cover all conflict-of-interest transactions, and instead relied on the common law rules to cover any transactions that were not specifically addressed in the statute.

There are, however, several common themes that explain why some transactions are regulated by statute rather than simply by the common law. These include:

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114 *See*, *for example*, N.Z. Neth. Socy v. Kuys [1973] 1 W.L.R. 1126.

115 *See*, *for example*, Gray v. New Augarita Porcupine Mines Ltd. [1952] 3 D.L.R.1 (Can.).

116 For examples, as well as discussion, of when a firm should be considered to be on the verge of insolvency, see Liquidator of W. Mercia Safetyware Ltd. v. Dodd and Anor [1988] 4 B.C.C. 30 (Eng.) and *Re* DKG Contractors Ltd. [1990] B.C.C. 903 (Eng.).

117 *See* Companies Act 1985, Part X (U.K.) (governing termination payments to directors, substantial property transactions between a company and its directors, and loans by a company to its directors). Companies Act 2006 contains similar provisions.

> The common law rules potentially are easily modified by provision in a company's charter. It is therefore easy to remove power from the general meeting of shareholders. For example, if a company has a standard clause in its charter, similar to the default provision in Table A, Regulation 85, the board can approve a conflict-of-interest transaction involving a director. In theory, the board can do so even if the contract is a huge and vital one and even if there is reason to believe that the directors who decided the matter might have been influenced by the director who was interested in the contract. If such influence could be proven, then the approval by the purportedly independent directors would not be effective; but proof of influence can be very difficult. Consequently, a more robust and mandatory mechanism, requiring approval by a shareholder meeting and not merely by directors, was considered to be appropriate for particularly risky transactions.
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> The common law rules are not well suited to control the activities of persons who are not themselves directors, but are connected or associated with a director in some way. The common law rules can control these activities only if it can be shown that a director was acting on behalf of others. However, in practice, this is difficult to prove. As a result, a stronger mechanism for approval of transactions with persons having specified types of connections to the company or its directors has been instituted.
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> For certain types of transactions, the risk of harm to the company may be high enough so that the fiduciary duties and remedies established by the common law may be insufficiently rigorous.

Public companies face additional regulation of conflict-of-interest transactions under the listing rules of the London Stock Exchange on "related party transactions."[118] Specific definitions are used as to define what constitutes a "related party" transaction. Broadly speaking, the definitions encompass situations where conflicts of interest amongst management are likely, or where substantial shareholders may be able to abuse their influence. The reasons for having this extra layer of rules are broadly similar to those which are said to justify the special rules discussed above which are included in the Companies Acts 1985 and 2006, but with the added element that formal control of those with influence over a company is more critical when the company's shares are widely held, which makes it more difficult for minority shareholders to respond to apparent conflict-of-interest transactions.

One problem is that directors and officers owe fiduciary duties to the company, and the company is the principal party entitled to enforce these duties, but the company is controlled by the directors. In theory, it has long been possible for shareholders to bring suit on behalf of the company (known as a "derivative" suit). However, in practice, the possibility to bring a derivative suit was narrowly limited by procedural rules. Moreover, recovery in such an action is for the benefit of the company as a whole, not the shareholder(s) bringing the action. Thus, shareholders often have limited motive to bring a derivative suit. In addition, the shareholders who bring the action bear the risk of

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118 LONDON STOCK EXCHANGE, LISTING RULES, Chapter 10.

paying most of the legal expenses of both sides if they lose, under "loser pays" English civil procedure rules. As a result, derivative actions have been very rare in the UK:[119] The Companies Act 2006 liberalizes the procedures for bringing derivative suits (we discuss these new rules in subchapter 8.1).

It is possible in some cases for a shareholder to bring a direct action challenging a conflict-of-interest transaction, relying on the unfair prejudice or oppression remedy.[120] This remedy was discussed above in the Canadian context. However, cases involving public companies are rare, because the economic incentives for a minority shareholder to bring such an action are limited.

The codification of fiduciary duties in the Companies Act 2006 does not include a general definition of what amounts to a conflict of interest or an indirect interest. As discussed in subchapter 1.2, the Companies Act 2006 moves some of the power to approve a conflict of interest transaction from the shareholder meeting to the board of directors.

United States

Transactions with directors and officers.

A transaction that involves a conflict of interest on the part of a director or officer implicates the common law duty of loyalty, which requires them to act in the interests of the company, when the company's interests are in conflict with their own interests. The existence of such a conflict subjects the transaction to close judicial scrutiny for the fairness of its terms.

Neither United States corporation law nor the common law has defined the concept of a conflict of interest. This concept is broadly construed by the courts to include any significant financial or nonfinancial interest possessed by a director or officer (although cases involving a nonfinancial interest are rare). It includes both transactions in which a director or officer profits directly at the company's expense; and transactions between affiliated companies that transfer value to one company from another.

In addition to the duty of loyalty, other important rules affect conflict-of-interest transactions. These include disclosure requirements under accounting rules and, for public companies, under securities law. These other rules are not addressed in this Report.

If a conflict-of-interest exists, and the transaction is not fully disclosed to and approved by a non-interested decisionmaker, the interested director or officer has the burden of proving that the transaction was "entirely fair" to the corporation. The director or officer is liable to the company for damages if he fails to prove this.

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119 *See* Law Commission for England and Wales, *Shareholder Remedies,* Consultation Paper No. 142 (1996); Law Commission for England and Wales, *Shareholder Remedies*, Final Report No. 246 (1997).

120 *See* Companies Act 1985, §§ 459-461 (U.K.); Clark v. Cutland [2003] EWCA Civ. 810, [2003] 2 B.C.L.C. 393.

As a practical matter, it is difficult for a director or officer to prove entire fairness. As a result, the usual approach is to obtain approval from a non-interested decisionmaker. However, there are also cases in which an interested director seeks this approval, fails to obtain it, causes the company to complete the transaction anyway, and accepts the likelihood of a lawsuit seeking damages, in which payment of some amount of damages is the likely outcome.

The concept of entire fairness has never been defined by the courts, nor have they explained how entire fairness is different from ordinary fairness. Presumably, if a fair price can fall within a range, an entirely fair price will have to be higher within that range than a price that is simply “fair.”

Approval of a conflict-of-interest transactions by a noninterested decisionmaker, usually the company’s independent directors, after full disclosure, will generally shift the burden back to the plaintiff to show lack of entire fairness. Even apart from its effect on burden of proof, this approval will make the judge more likely to conclude that the transaction was fair, and therefore to award no damages. Conversely, the failure of an interested director or officer to obtain approval by a noninterested decisionmaker, when it was possible to do so, will make the judge inclined to believe that the transaction is probably not fair and would not have been approved, and that this lack of fairness is an important reason why approval was not sought.

The noninterested directors will be drawn from the ranks of the company's outside or non-executive directors. Inside or executive directors are presumed to be interested in a conflict-of-interest transaction, even if they have no personal financial stake in the transaction, because their continued employment requires them to stay on good terms with other inside directors and with the company's controlling shareholders. In contrast, outside directors’ interest in keeping their positions as directors is not considered to be a sufficient interest to prevent them from being considered to be disinterested.

Ideally, most and perhaps all of the directors who review a conflict-of-interest transaction should be "independent" outside directors, with no other significant connection to the company or its insiders. "Affiliated" outside directors, who have (or might want to have) a business connection to the company, are not ideal for reviewing conflict-of-interest transactions, because of their interest in doing business with the company. Most decided cases, however, adopt a generous view as to which directors should be considered to be noninterested, and do not draw a distinction between affiliated outside directors and independent directors.

The procedural strategy of approval by noninterested directors can work only if a company has a reasonable number of independent directors. It can work *well* only if these directors are *in fact* independent of the executives. Otherwise, the procedures can become camouflage for a transaction that benefits the insiders at the company's expense. Whether the directors behave as if they are truly independent varies from company to company. The decided cases provide examples where independent directors behaved in an exemplary manner, examples in which they behaved in an execrable matter, and a full range of cases in between these extremes.

True independence will often turn on the ethical sensitivity of particular directors, which will depend heavily on cultural norms. In the United States, cultural norms of independence are reinforced by a vigorous financial press, which is quick to criticize directors who approve conflict-of-interest transactions under circumstances where fairness to the company is in doubt. Thus, the approach of reliance on independent directors to approve conflict-of-interest transactions works decently, if not perfectly.

In principle, approval by a vote of disinterested shareholders will also shift the burden of proof to an unhappy shareholder to show lack of entire fairness. However, the usual practice is to seek approval by noninterested directors, rather than approval by shareholders.[121]

If a conflict of interest transaction is completed without disclosure, it can be challenged when it is discovered by the company or by shareholders. If such a transaction is discovered after it is completed, it remains possible for the transaction to be ratified as fair by a disinterested decisionmaker – either noninterested directors or, less commonly, noninterested shareholders. Ratification has the same effect as advance approval in shifting the burden of proof on fairness back to the plaintiff.

For the most part, directors and officers do not face criminal liability for their conduct. One exception is completion of a conflict-of-interest transaction without disclosure to the board of directors. This can be seen as a form of theft, and can lead to criminal prosecution.[122]

Fair process

For especially important transactions, such as a freezeout (a purchase of the minority shares by a controlling shareholder) or, more generally, a going private transaction (a purchase of the minority shares by a company associated with the company's managers, even when they do not hold a controlling share interest), or a purchase of a significant portion of the company's assets, the courts insist not only on approval by noninterested directors, but also on a negotiation process which approximates arms-length negotiations, in order to shift the burden of proof back to the plaintiff to show lack of entire fairness. To satisfy this procedural requirement, which can be called "quasi arms-length negotiations," the noninterested directors must have the opportunity to select and use

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121 The company laws of many states provide that a transaction involving a conflict of-interest on the part of a director or officer is not void or voidable solely because it involves a conflict of interest, if certain procedural steps are followed. *See, for example*, DELAWARE CODE ANNOTATED title 8, §144 (2007). One might think that this means that if these procedural steps are not followed, the transaction *is* void or at least voidable. This is not correct. Instead, these statutory provisions merely overrule an old common law doctrine, under which transactions *were* void or voidable solely because of the existence of a conflict of interest. This old common law rule has largely been abandoned, but the statutory provisions remain. For discussion of these confusing statutory provisions, see ROBERT C. CLARK, CORPORATE LAW § 5.2.1 (1986).

122 In one recent case involving Tyco, outside director Robert Walsh suggested that Tyco acquire another large company. As compensation for making this introduction, Tyco's CEO agreed that Tyco would pay Mr. Walsh a fee of $20 million. This fee was not disclosed to the other directors. When it was later discovered, Mr. Walsh faced both a civil lawsuit by the Securities and Exchange Commission and a criminal investigation for his undisclosed compensation. He settled both by returning the fee and paying a large criminal fine. This same fee would have been difficult for shareholders to challenge if it had been disclosed to the Tyco board in advance and approved by the board.

their own legal and financial advisors, and must have the power to reject the transaction altogether.

Delaware case law suggests that good process can justify a lower price than a judge would accept without that process. This may seem odd at first glance, but in fact makes good sense. The use of a good process gives the judge more comfort that the price that was paid is in fact reasonable. What is a fair price is hard for a judge, who sits at some distance from the transaction, to determine. The judge must sift through the claims of opposing expert witnesses that: (a) from the plaintiff's side, the price is absurdly low; and (b) from the defendant's side, the price is far higher than fair and was paid only out of the goodness of the defendant directors' hearts. (Why the defendants would be so generous is rarely explained.) The directors' use of a good process can persuade the judge that the actual price is close to what arms-length negotiations might have produced.

For a transaction of sufficient importance, U.S. public companies usually appoint a special committee of independent directors to conduct these quasi-arms-length negotiations. This is partly because of the need to follow good process in order to shift the burden of proof to the plaintiff. The independent directors also know that if they use a different procedure, they may be criticized by the financial press, and could also face a lawsuit before a skeptical judge, who knows that the directors could have used better procedures but chose not to.

The American courts' focus on the procedures that a company follows when approving a conflict-of-interest transaction is part of a more general American emphasis on procedure when judges review company decisions. Our judges are very reluctant to decide for themselves the substantive merits of a business decision. They often focus instead on whether the company followed good procedures. They then presume, within fairly broad parameters, that if proper procedures were followed and the decisionmakers appear to be disinterested, the outcome should be accepted. For conflict-of-interest transactions, the courts recognize that good procedures sometimes camouflage a dirty transaction, so they are attentive to substantive fairness. For other transactions, in contrast, good procedures will permit a company to complete almost any transaction, no matter how foolish, by relying on the protection of the business judgment rule.

Derivative suits and the remedy for breach

Occasionally, a lawsuit is filed before a conflict-of-interest transaction is completed, and a court can intervene with an injunction against the transaction, if fair procedures were not followed or a fair outcome is not expected. Usually, though, the courts move too slowly for this remedy to be feasible. Unhappy shareholders must then pursue a lawsuit after the transaction has been completed. The most common remedy for a completed transaction is damages, payable by the directors who approved the transaction. Our courts are very cautious about unwinding a completed transaction, and will almost never do so if there is a risk of harm to a third party who has acted in good faith.

The form of the lawsuit is usually a suit by a shareholder in the name of the company, where the damages will be paid by the directors or officers who benefit from a transaction) to the *company*, not to individual shareholders. We call this a *derivative suit.* The derivative suit ensures that all shareholders can share *pro rata* in the recovery through their ownership of the company's shares. The minority shareholders remain at risk that the directors, having tried to self-deal once and failed, will try again, in a more creative manner, to extract funds from the company.

In the United States, unlike many other countries, lawyers are allowed to charge contingency fees and each side generally pays its own legal expenses. Although the damages from a derivative suit are paid to the company, the shareholders' lawyers are paid directly, with payment coming most commonly from directors' and officers' insurance. In practice, the shareholders' lawyers are often the principal beneficiaries from a derivative lawsuit. They act, in a way, as private policers of good company behavior.

The United States would surely get less vigorous enforcement of fiduciary duty if we had a different system for paying legal fees. How much less enforcement we would get is a difficult question. Whether we would be better off with fewer derivative suits is a question on which our scholars disagree.[123i]

Summary and recommendations

The need to regulate conflict-of-interest transactions is perhaps the most important single problem that must be addressed by an effective company law. The JSC Law addresses this problem in two separate ways, through liability based on fault for breach of the duty of good faith, under JSC Law art. 71, and through special review and approval for transactions which may involve a conflict of interest on the part of a director or manager, under JSC Law chapter 11. We recommend here a definition of the concept of a conflict of interest for purposes of fault-based liability under art. 71.

For the most part, the overview of the comparison countries did not focus on the details of how one would define a conflict of interest. In the U.K. and the United States, the courts are charged with determining when a conflict of interest exists, in order to determine whether a challenge to the actions of directors should be evaluated under the duty of care or under the much stricter duty of loyalty. They have resisted providing precise definitions, in order to be able to capture novel and indirect conflicts. Similarly, in Canada, the core statutory term "material interest" is not defined either in the statute or in case law. In the European Union, a 2005 Recommendation refers to, but does not define, the concept of a "material conflict of interest."

However, several guiding principles emerge from a review of experience in other countries. First, the concept of a conflict of interest is difficult to define. Therefore, any effort to define it should begin with a general statement, and can then perhaps list some examples of situations in which a conflict of interest can arise. These examples should explicitly be made nonexclusive. In our judgment, it would be better for the law to offer only a general statement addressing the concept of a conflict of interest, and not to provide specific details.

Second, it is necessary to address both direct and indirect conflicts of interest. An indirect conflict can arise, for example, when a director has a financial interest in another company, which engages in a transaction with the company of which he is a director.

123 For a skeptical view of the value of derivative suits, see Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 JOURNAL OF LAW, ECONOMINS AND ORGANIZATION 55 (1991).

This financial interest can be held directly or it can be held indirectly, through intermediaries or through securities or other means which provide a financial interest without direct ownership.

Third, the basic concept of conflict of interest, for a transaction by the company, is that a director, manager, or controlling shareholder, or his affiliated persons, will realize some financial or other advantage from a transaction with the company. In most cases, this advantage will be financial. But sometimes, it can be nonfinancial - a business opportunity, or support for a personal interest that is unrelated to the welfare of the company.

Fourth, a potential for conflict of interest also arises if a director, manager, or controlling shareholder has business interests that overlap with those of the company. The concern here is not that the company will engage in an unprofitable transaction (or a transaction which is profitable, but less profitable than it would have been if entered into between true third parties), but that it will fail to engage in a profitable transaction, leaving the business opportunity to be taken by the director, manager, or controlling shareholder.

Fifth, to be effective, the concept of conflict of interest must include not only directors and senior managers, but also controlling shareholders. The remedies available when a conflict arises may be different for members of the board of directors or the executive organ than for controlling shareholders. In Canada, for example, transactions for which a controlling shareholder has a conflict of interest are addressed under the oppression remedy. In the United States, in contrast, these transactions are addressed by extending a limited duty of good faith to controlling shareholders.

We have not been asked to address the concept of an "affiliated person." We assume that this concept is satisfactorily defined elsewhere in the law. We note, however, that this concept must cover both close relatives and companies in which a director or manager has a sufficiently large direct or indirect financial interest.

Definition of conflict of interest

With the above concepts in mind, we recommend the following definition.

> A person has a conflict of interest with respect to a transaction with a company if the person, or his affiliated persons, directly or indirectly, will realize a financial or other advantage from a transaction with the corporation. A person has a conflict of interest with respect to a decision by the company if the person, or his affiliated persons, directly or indirectly, will realize a financial or other advantage based on the decision taken by the company.

This definition is highly general, and is not limited to transactions involving a director, manager, or controlling shareholder. However, only directors, managers, controlling shareholders, individual managers, managing organizations, and the directors and managers of managing organizations will have any duty to the company to refrain from engaging in actions involving a conflict of interest. If desired, the definition could be limited to specific classes of persons to begin with. It might then read:

> A member of a company's board of directors, a member of the company's management, a controlling shareholder, or another person having a duty to act in good faith with respect to the company, has a conflict of interest with respect to a

> transaction with the company if this person, or his affiliated persons, directly or indirectly, will realize a financial or other advantage from a transaction with the corporation. A member of a company's board of directors, a member of the company's management, a controlling shareholder, or another person having a duty to act in good faith with respect to the company, has a conflict of interest with respect to a decision by the company if the person, or his affiliated persons, directly or indirectly, will realize a financial or other advantage based on the decision taken by the company.

This definition does not refer to a threshold amount of advantage that must be realized, in order for a conflict of interest to exist. In our judgment, this is appropriate. The standards for review and approval by the company of a transaction involving a conflict of interest with a director, manager, or controlling shareholder will, of course, vary depending on the scale of the transaction. But the concept applies both to large conflicts and to small ones.

If desired, the concept could be limited by using the concept of a "material" conflict of interest. This is the approach taken in Canada. But one is then left with the undefined term "material", which resists definition because an amount that would be highly important to one person might be unimportant to another.

This definition of a conflict of interest is not self-enforcing. Instead, it forms a core part of the definition of good faith (subchapter 1.2), and the determination of whether the directors who adopt a decision to approve a transaction should benefit from a presumption of reasonableness, good faith, or both (subchapter 1.3). We recommend that a director, a member of the company's management organ, or a controlling shareholder (see subchapter 1.5) who acts with a conflict of interest should be presumed to have violated the duty of good faith unless this person shows that he acted in good faith, including providing appropriate disclosure about the nature of the conflict and the transaction, ensuring appropriate approval of the conflict-of-interest transaction, and showing that the transaction was fair to the company.

Recommendations for improved functioning of the board of directors

Delayed approval of de minimis transactions

The JSC Law provides procedures for approval of a specified class of transactions which may involve a conflict of interest, including approval by non-interested members of the board of directors for all transactions within this class, and approval by non-interested shareholders of larger transactions. Experience suggests that it can be burdensome for the board of directors to be required to review and approve very small transactions before they can be completed, and that may be appropriate to allow companies to establish a threshold amount, below which a transaction would not require advance approval by non-interested members of the board of directors. Instead, the board of directors could approve any transactions which fell below this threshold amount once per year, in connection with its review of the company's annual financial statements. The transactions which are exempted from advance approval would still be required to be fair to the company, in accordance with the duty of good faith of the director, manager, or shareholder who has a self-interest in the transaction.

More specifically, we recommend that companies be permitted to adopt a charter provision, establishing a threshold amount, not to exceed the amount at which a transaction would require approval of non-interested shareholders, such that a transaction in the completion of which an interest exists, which falls below this threshold amount, shall be disclosed to the board of directors at the next meeting of the board of directors after the completion of the transaction, and shall be reviewed and approved by the non-interested members of the board of directors in accordance with JSC Law art. 83 at the earlier of (i) the date when all such transactions, in the aggregate, reach the threshold amount, or (ii) the date of approval by the board of directors of the company's annual financial statements for the year in which the transaction was completed.

Subchapter 1.5 Conflict of interest for transactions with controlling shareholder

How should the law regulate the conflict of interest of managers and directors during conclusion of a transaction between a company and a controlling shareholder?

General comment

For contracts between a corporation and a controlling shareholder, who is not a director of the company, the remedies available to shareholders are much more limited, as compared to conflict-of-interest transactions involving a director or officer. The directors of the company, unless they have a clear connection to the controlling shareholder, will generally be considered to be independent. Thus, they have the power to approve the transaction on behalf of the company.

This is true even though the directors will understand that they can continue in office only with the approval of the controlling shareholder, who will cast the deciding vote at the next general meeting of shareholders. In effect, the directors' interest in preserving their own position is *not* considered to be a conflict of interest, sufficient to disable them from approving a transaction with a controlling shareholder. In practice, of course, some directors behave independently, and some do not.

Russian context

The concept of "conflict of interest," while not defined by Russian corporate law, is nevertheless used in both legal precedent and literature. Some laws include individual provisions relating to the concept of "conflict of interest." For example, the provisions of the JSC Law on self-interested transactions can be understood as covering a class of transactions which pose a risk of a conflict of interest, even though not all of these transactions will involve an actual conflict.

A definition of the concept of "conflict of interest" as it pertains to professional participants in the stock market is provided in a 1998 Decree of the Federal Commission on Securities.[124] Under this decree, a conflict of interest is a conflict between the

124 Decision of the Federal Commission on Securities No. 44 "On the Prevention of Conflict of Interest in the Performance of Professional Duties in the Stock Market" (Nov. 5, 1998) (Постановление

material and other interests of a professional participant in the stock market (and/or his employees) and the client of the professional participant, as a result of which the action (inaction) of the professional participant (and/or his employees) results in losses or other adverse consequences for the client. The Code of Corporate Governance, which is advisory in nature, mentions but does not define conflict of interest (ch. 3, § 2.1.2): a conflict of interest provides grounds for doubting that a member of the board of directors will act in the interests of the company.

A conflict of interest can arise in various areas of the company's operations, including decisions by the company's management organs, where a member of these organs, or an important shareholder, has a financial or other interest in a transaction, and transactions that affect the relative rights of majority and minority shareholders, and a dispute between the company and its shareholders. In legal practice, the term "conflict of interest" is encountered most frequently in transactions involving a self-interest as defined in the JSC Law.[125]

The problem of "conflict of interest" can be resolved in two ways. First, by means of "disclosing and overcoming" it. For example, situations of potential conflict can be listed in the law and in a company's charter, and the company's management organs can then avoid these situations in the operations of the company, or approved by non-interested members of the management organs or by non-interested shareholders. This is the approach taken in the JSC Law.[126] Second, the law can provide remedies for shareholders or other aggrieved parties if a conflict of interest should arise, through compensation of losses or invalidation of the transaction.

In practice, it can be difficult in practice to prove that the company or its shareholders suffered losses. On the other hand, if the law allows the invalidation of transactions involving a conflict of interest, based solely on the existence of the conflict, without proof of losses, this could lead to suits by shareholders who have not been harmed, in order to harass the company's managers or obtain a payoff to end the lawsuit. The JSC Law currently does not expressly require proof of loss, as a condition for invalidation of a transaction. However, a current legislative proposal would permit invalidation only if harm is proved.

In our view, the issue of conflict of interest in corporate law is connected to the concept of the independence of directors. The JSC Law does not define the concept of director independence. Independence can have two meanings -- independence with respect to a particular transaction, and independence in a director's overall relationship to the

Федеральной Комиссии по Рынку Ценных Бумаг от 05.11.1998 №44 «О предотвращении конфликта интересов при осуществлении профессиональной деятельности на рынке ценных бумаг»).

125 *See* Decision of the Federal Arbitrazh Court of the North-Western District No. A56-45342/04 (May 4, 2006) (Постановление Федерального Арбитражного Суда Северо-Западного Округа от 04.05.2006, № А56-45342/04); Decision of the Federal Arbitrazh Court of the Ural District No. F09-2729/2004-GK (Aug. 25, 2004) (Постановление Федерального Арбитражного Суда Уральского Округа от 25.08.2004 № Ф09-2729/2004-ГК); Decision of the Federal Arbitrazh Court of the North- Caucasian District No. F08-1780/2005 (Jun. 1, 2005) (Постановление Федерального Арбитражного Суда Северо-Кавказского Округа от 01.06.2005 № Ф08-1780/2005).

126 *See* Subchapter 1.4 for discussion of the JSC Law provisions on self-interested transactions.

company. Under the JSC Law, a director is considered independent, for purposes of approving a particular self-interested transaction, if he does not have a self-interest with respect to the transaction that is being considered.

With regard to the second, more general concept of independence, the Code of Corporate Governance ch. 3, § 2.2.1, provides a unified definition of an independent director; develops the criteria for designating directors as independent; recommends that an independent director, after seven years of performing his duties, should no longer be considered independent; and recommends the presence of at least three independent directors on the board of directors.[127]

An FSFM regulation which applies to publicly listed companies, also defines director independence. To be considered independent, a director should not, when elected to the board and for one year prior to election, be an officer or an employee of the company; should not be a spouse, parent, child, brother or sister of the company's officers; should not be a government representative; etc.[128]

The JSC Law includes a procedure for the disclosure of information that may reveal possible conflicts of interest. Each joint-stock company must provide an annual report to shareholders; which includes information prescribed by FSFM. FSFM regulations require disclosure of information about the members of the board of directors, the common shares of the company that belong to them, their purchases and sales of shares; changes in the indicated shares; the company's subsidiary companies; etc.

The concept of an "indirect interest" does not exist in Russian law and is thus not encountered in legal practice.

In sum, despite the absence of a legal definition of the term "conflict of interest," both the term and the relations which it describes are frequently employed in legal practice. Legislative regulation of "conflict of interest," however, is urgently needed.

Canada

A minority shareholder who wants to challenge a transaction between a company and a controlling shareholder will probably have to apply for relief, under a statutory rule that allows shareholders in Canada, like their counterparts in the U.K., to bring a lawsuit seeking damages on the grounds that the minority shareholders' interests have been unfairly prejudiced by action by the corporation (CBCA § 241, OBCA § 249).[129] This form of relief, known in Canada as the "oppression remedy," is available for both private

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127 Russian practice is to consider directors as falling into three categories: executive, non-executive, and independent directors. Under the JSC Law, executive directors who are members of the collegial executive organ cannot constitute more than one-fourth of a company's board of directors.

128 Order of the Federal Service for the Financial Market, No. 04-1245/pz-n /On the Acceptance of the Sub-law on the Organizational Operations on Trade on the Stock Market/ (Dec. 15, 2004) (Приказ Федеральной Службы по Финансовым Рынкам от 15.12.2004, №04-1245/пз-н «Об утверждении Положения о деятельности по организации торговли на рынке ценных бумаг»). This order is no longer in force, but is the most recent regulatory effort to define the concept of director independence.

129 *See* J. ANTHONY VANDUZER, THE LAW OF PARTNERSHIPS & CORPORATIONS 327 (2ND ed. 2003).

and public companies, but in practice it is used primarily by shareholders in privately held companies.[130]

In the context of private companies, there are numerous cases where "oppression" has been found where there has been a transfer of corporate assets to key shareholders without a fair price being paid to the corporation, there was not been a proper valuation of the assets or the asset transfer has left the corporation unable to pay its debts.[131]

The fact that a company's board of directors has endorsed a transaction between the company and a dominant shareholder is unlikely to affect the outcome of a suit based on the oppression remedy. This is particularly likely to be the case if the directors who approved the transaction were not fully independent of the dominant shareholder.

It is possible that a judge would take into account the recommendation of a special committee of outside directors that the transaction should be considered fair to the corporation, if none of the directors serving on the committee had a connection with the dominant shareholder. However, there is very little Canadian case law on the weight to be attached to deliberations of independent board committees.

Controlling shareholders do not, in general, owe a fiduciary duty of loyalty to the corporation or to minority shareholders. Thus, breach of fiduciary duty by a controlling shareholder will probably not provide a basis for a minority shareholder to challenge a transaction by the company in which a controlling shareholder had an interest. Canadian courts impose fiduciary duties on controlling shareholders only in special circumstances, such as where one shareholder undertakes to advise another in circumstances where there is an element of trust and confidence between them.[132]

European Union

A new European Union directive (to be implemented by Member States by 2008) contains requirements for disclosure of conflict of interest transactions, including transactions with a controlling shareholder.[133] The directive amends several prior

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130 DENNIS H. PETERSON, SHAREHOLDER REMEDIES IN CANADA §§ 18.144, 18.208 (1989); Stephanie Ben-Ishai, *The Promise of the Oppression Remedy: A Review of Markus Koehnens Oppression and Related Remedies*, 42 CANNADIAN BUSINESS LAW JOURNAL 450, 455 (2005); Stephanie Ben-Ishai and Poonam Puri, *The Canadian Oppression Remedy Judicially Considered: 1995-2001*, 30 QUEENs LAW JOURNAL 79, 92 (2004) (noting that, of 71 oppression remedy cases launched between 1995 and 2001, only 6 cases, an average of one case per year, involved a public company).

131 MARKUS KOEHNEN, OPPRESSION AND RELATED REMEDIES 129 (2004).

132 Kevin P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 879-80 (1999).

133 Council Directive 2006/46, 2006 O.J. (L224/1) (EC) (Aug. 16, 2006) (amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings).

accounting directives. New art. 43(7b) of the Accounting Directive (78/660/EEC) requires firms to disclose in the notes to the annual accounts:[134]

- transactions by the company with related parties, including the amount of such transactions; and
- the nature of the related party relationship and other information about the transactions necessary to understanding the company's financial position, if the transactions are material and were not concluded under normal market conditions.

Information about similar transactions may be aggregated except where separate information is needed for investors to understand the effects of related party transactions on the financial position of the company. Member States may partly exempt smaller companies, in which case only transactions with major shareholders and members of the administrative, management and supervisory bodies need to be disclosed. Member States may also exempt "transactions entered into between two or more wholly owned subsidiaries of a common parent company.

For the definition of who is a related party, the directive refers to International Accounting Standard (IAS) 24.9.[135] The definition includes parties that control the firm or have a significant influence over it, associates of these persons, joint ventures, key management personnel, close family members of or entities controlled or influenced by such parties, and pension plans for the benefit of the company's employees or the employees of a related party.

France

With regard to transactions between a company and a controlling shareholder, there are several protections included in French company law. First, as noted above, the directors who are not directly interested must approve the transaction. Second, if the controlling shareholder attempts to influence the directors' decision, this can be seen as an abuse of majority power, and gives rise to liability on the part of the controlling shareholder.[136]

Third, the non-interested shareholders have to approve the transaction (Code de Commerce, art. L. 225-40). Thus, (at least in theory) the interests of the other shareholders are safeguarded.

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134 A parallel provision was added as new article 34(7b) of the Consolidated Accounts Directive (83/349/EEC). Intra-group transactions need not be reported in the notes to Consolidated Accounts.

135 The overall system of international accounting standards is now called International Financial Reporting Standards, but older standards retain their original designation as International Accounting Standards.

136 *Cf.* Cass. com., Apr. 18, 1961, Bull. civ. IV, No.2 (Piquard) (noting that the concept of abuse of majority control forbids the taking of a decision against the overall company interest or for reasons of personal favouring of the majority over the minority).

At the same time, most French companies do not have a significant number of truly independent directors. In practice, therefore, the directors may sometimes approve transactions that benefit the controlling shareholder at the expense of the company.

Germany

The AktG does not include specific rules on the approval of conflict-of-interest transactions involving a controlling shareholder. However, in limited situations in which a transaction is subject to a shareholder vote, a controlling shareholder may run afoul of voting prohibitions. Under AktG § 136 I, shareholders are prohibited from voting when a shareholder vote is taken on whether the company's claim against them should be enforced, or whether they should be relieved of a liability to the company. Courts have refused, however, to extend these specific prohibitions to other situations involving a conflict of interest on the part of a controlling shareholder.[137]

Another provision that may be relevant in situations where a controlling shareholder has a conflict of interest is AktG § 57, under which capital contributed to the company by shareholders may not be returned to shareholders, other than through dividends paid out of accounting profits. This provision is interpreted to include "concealed distributions", which typically are non-arms-length contracts between the company and major shareholders. Typically, claims against shareholders from such a transaction are made in bankruptcy.[138]

There is abundant case law on concealed distributions by companies to shareholders. Generally, a "concealed distribution" is defined as a transaction the company would not enter into with an independent third party.[139] According to the case law, there is no requirement that the plaintiff prove subjective elements (such as intention to harm the company) to establish such a claim.[140] Most of the cases on concealed distributions involve limited liability companies, but the concept applies to joint stock companies as well. A distribution to shareholders is permitted if, after the distribution, the firm's net assets (total assets minus total liabilities) exceed its stated capital. Joint stock companies can make distributions only through dividends. Thus, a distribution in another form is unlawful regardless of the level of the company's net assets.

In addition to these statutory provisions, several German Supreme Court cases indicate that there is a fiduciary duty among shareholders.[141] However, according to recent

137 BGHZ 97, 28, 33.

138 *See* Holger Fleischer, *Disguised Distributions and Capital Maintenance in European Company Law, in Legal Capital in Europe*, EUROPEAN COMPANY AND FINANACIAL LAW REVIEW, special volume 1, at 94 (2006).

139 UWE HÜFFER, AKTIENGESETZ § 57, ¶ 8 (7th edition 2006).

140 BGH NJW 1987, 1194, 1995; BGH NJW 1996, 589, 590.

141 See BGH, BGHZ 103, 184, 194-5 (*Linotype*) (majority shareholder initiated the dissolution of the company against the asserted interests of the minority shareholders); BGH, BGHZ 129, 136, 148 (*Girmes*) (minority shareholder sought to block a recapitalization of the company); BGH, NJW 1999, 3197.

decisions, resolutions passed by a "qualified majority" (75% of the votes) may carry their justifying reason within themselves,[142] and courts have not examined the reasonableness of a delisting resolution[143] Thus, there is a trend to reduce judicial control.

Even if a conflict-of-interest transaction with a controlling shareholder does not require special approval procedures, it may require disclosure. The disclosure requirements arise both under the European Commission directive, discussed earlier in this chapter, and under International Financial Reporting Standards.[144]

Korea

The tendency for directors to approve a transaction proposed by a controlling shareholder, even when the transaction is likely to harm the company, is perhaps the single most controversial issue in Korea. Many shareholder rights activists argue that not only a director's financial interest, but also the director's interest in keeping his position, may cause a conflict in the common situation where a company has a controlling shareholder, who often manages the company, and in any event will control who is elected to the board of directors. Korea is a society heavily governed by personal relationships, and is sometimes characterized as having, in part, an economy based on these relationships. Such personal relationships are built and maintained by implicit arrangements. It often happens that a transaction involves a conflict which is not apparent, is concealed and is flatly denied when the transaction becomes an issue due to exposure in the press or through a shareholder lawsuit.

The principal relevant statutory provision is KCC art. 382-3, which establishes a general obligation of directors to act in the interests of the company. Even this provision is fairly recent; it was added only in 1998 as part of Korea's broader response to the East Asian financial crisis.

> *Article 382-3 (Duties of Directors to be Faithful).*
>
> Directors shall perform their duties faithfully for the good of the company in accordance with laws, subordinate statutes, and the articles of incorporation.

Major public companies. Under KSEA art. 191-19, a public company with total assets of 2 trillion Korean won or more (roughly U.S. $ 2 billion) must obtain board of directors approval for a transaction between the company's largest shareholder (who is often a director) and the company, and provide information about the transaction to the next general meeting of shareholders held after the board of directors approves said transaction.

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142 See BGH, BGHZ 76, 352; 103, 184.

143 BGH, BGHZ 153, 57 (*Macrotron*).

144 *See* INTERNATIONAL ACCOUNTING STANDARD 24.22 (2002).

United Kingdom

The common law rules governing approval of a conflict-of-interest transaction literally apply only when the person with the conflict is a director or officer, who owes a fiduciary duty of loyalty to the company. A controlling shareholder does not owe such a duty. Often, if the controlling shareholder is an individual, that individual will also be a director and then the usual rules can be applied. In other cases, where the controlling shareholder is another company, the company will have representatives on the board of the company, and the usual rules will apply to those representatives, who are considered to have a conflict of interest.

In both situations, the courts treat directors who are not directly connected with the controlling shareholder as noninterested, and give full effect to approval of a transaction by these directors (assuming they have the power under the charter to approve the transaction and have been fully informed about it – see above for discussion of these issues).

The common law rules are not well suited to control the activities of a controlling shareholder who is not a director and does not directly have representatives on the board. Transactions between a listed company and a major shareholder are, however, addressed in the London Stock Exchange Listing Rules. Chapter 11 of the Listing Rules governs transactions between a company and "related parties"; which are defined to include a shareholder who controls 10% or more of the votes in a company (or its parent, subsidiary or co-subsidiary). Broadly, chapter 11 requires disclosure of a proposed related party transaction to shareholders, and approval by vote of noninterested shareholders.

Both the Companies Act and the Listing Rules include the concept of a “shadow director” who acts in a manner similar to a director or senior officer but without a formal title, often by giving instructions to the company's directors and officers. A transaction in which a shadow director has an interest must be approved in the same manner as a transaction with an actual director.

United States

A controlling shareholder owes a limited fiduciary duty to the corporation when the controlling shareholder engages in a transaction with the company. In most circumstances, this duty makes the controlling shareholder liable for the difference between the consideration received by the company and fair consideration, with the burden placed on the controlling shareholder to show that the transaction is entirely fair to the corporation.

One important exception to this general rule involves a freezeout offer by the controlling shareholder for all minority shares. If the controlling shareholder can acquire 90% of the company’s shares in the market, the controlling shareholder can then freeze out the remaining shares, with no direct duty to offer a fair price. The minority shareholders will still have an opportunity to obtain the fair value of their shares through an appraisal proceeding.[145]

The controlling shareholder is also free to make a tender offer for minority shares, without an obligation to show fairness of price. This is treated as a private transaction between the controlling shareholder and the selling shareholder, in which each can act in its own interest.

For a transaction where a controlling shareholder would bear the burden of proving entire fairness, the burden can be shifted back to the plaintiff to show lack of fairness through approval by a disinterested decisionmaker. For the most part, the rules on disinterested approval are similar to those for transactions in which a director or officer has a conflict of interest.

The presumption that an outside director does not face a conflict of interest due to the desire to remain on good terms with a controlling shareholder is under the greatest stress for a transaction with a controlling shareholder, as compared with a transaction with a non-controlling fellow director, or an officer of the company. However, the case law does not distinguish between these situations, and treats an outside director as independent in all cases, unless an interest other than keeping one's position can be shown.

Summary and recommendations

The question of how to address transactions in which a controlling shareholder has a conflict of interest is clearly both important in practice and difficult to solve. Other countries have struggled with this question as well.

Some of our recommendations are presented in the earlier Subchapters. First, if the company completes a transaction for which a controlling shareholder has a conflict of interest, we recommend that even non-interested directors should not benefit from the business judgment rule or another presumption of reasonableness. See subchapter 1.3. However, one must also address the practical reality that even apparently non-interested directors may have a practical conflict because they were typically elected by the controlling shareholder and depend on the controlling shareholder for continuing in their positions. We therefore recommend placing the burden of proof on the non-interested directors to show that their approval of the transaction was both informed, and reasonable in substance.

Second, we also recommend that the concept of a conflict of interest should be defined broadly, to capture both direct and indirect ways in which a controlling shareholder may realize a personal advantage from a transaction with a company that he controls. See subchapter 1.4.

Third, we recommend that the controlling shareholder should be subject to a requirement of good faith in his dealings with the company. This duty should apply when the controlling shareholder, or his affiliated persons, engages directly or indirectly in a

145 *See* Guhan Subramanian, *Fixing Freezeouts*, 115 YALE LAW JOURNAL 2, 20 (2005).

transaction with the company. It would largely be satisfied by ensuring that the conflict is disclosed in advance to the company and the transaction has been approved by non-conflicted members of the board of directors, is fair to the company, and has been approved in compliance with JSC Law chapter 11, if this chapter is applicable. See the proposed definition of good faith in subchapter 1.2.

Fourth, because of the special risk that a controlling shareholder will influence the decision by the board of directors to approve a transaction for which he has a conflict of interest, we recommend that the controlling shareholder should be required to provide to the company the material information about the transaction that an independent decisionmaker would want to have in order to adopt a decision on the transaction. That is, it should be the responsibility of the controlling shareholder to provide information, as well as the responsibility of the company's board of directors to obtain the information they need to make a decision.

Fifth, we recommend that the duty of good faith, as applied to a controlling shareholder, should include a requirement that the controlling shareholder should not, directly or indirectly, put pressure on the company's directors or managers in order to obtain their approval of the transaction. Implicit pressure will exist in any event; the controlling shareholder should not act in a way that adds to this pressure. We recognize that proving the existence of such pressure will often be difficult.

Subchapter 1.6. Additional bases for the civil liability of company directors and managers

Issue: Should there be additional bases for the civil liability of directors and managers under company law, beyond those in current legislation? Should these be specified, in the JSC Law or in a contract between the company and its directors or managers?

General comment

The comparative analysis will address the principal sources of civil liability currently faced by directors, in addition to their fiduciary duties and potential liability under company law, with the following limitations. Liability that arises under insolvency law is addressed in a separate question. Administrative liability is addressed in a separate question. Criminal liability is addressed in a separate question.

As a practical matter, in all of the countries considered, the practice of explicitly imposing additional liability on members of the board of directors, beyond the liability specified in company law, either in the company charter or by contract, is not common. Indeed, to our knowledge it does not exist. Instead, the usual debate is over the extent to which the company, through a provision in its charter contract or through an indemnification contract, can reduce the liability faced by a director or officer, or otherwise protect a director or officer against the liability that this person would normally face under company law or other sources of law.

Thus, the question of whether additional bases of liability should be stated in the law or in a contract is not meaningful in practice, and will not be addressed. To be sure, if the company law were to prescribe no obligations of directors, or only minimal obligations, companies might impose some obligations in their charters or as a matter of contract. Companies which failed to do so could find themselves unable to sell their shares to investors. But this is not the situation in any of the studied countries.[146]

Russian context

Liability of the individual executive organ for signing a securities prospectus

To certify the reliability and completeness of the information contained therein, a securities prospectus should be signed by a person carrying out the functions of the issuer's single-person executive organ (Law on the Securities Market 22.1(2)). This individual and the other persons who signed the securities prospectus have joint and several liability for damages caused to a purchaser of securities as a result of unreliable, incomplete or misleading information which they certified. Because the prospectus is signed by several persons (e.g., the company's chief accountant, an independent appraiser, etc.), each of these persons is liable solely for the reliability of the information within his area of competence.

As a general rule, the elements of liability for information contained in a securities prospectus are as follows:

1) damages caused to a possessor of securities;
2) causation between the actions of the -person who signed the prospectus containing unreliable information and the damages incurred; and
3) fault.

The issuer of the securities has primary liability for damages due to an unreliable prospectus, while the person carrying out the functions of the individual executive organ has only secondary liability, if the company does not pay the damages. The shareholder thus first needs to bring action against the issuer. In practice, then, the person carrying out the functions of the individual executive organ is at risk of paying damages personally primarily when the company is insolvent.

Liability of members of management organs for preserving confidentiality

By virtue of his position, a member of a company's management organs will often have access to confidential information. Under Civil Code art. 139:

146 For a limited time, Canada was a partial exception. A number of companies are publicly traded using a tax-motivated entity called an income trust, which is governed by trust law, and holds all of the shares, and most or all of the debt of an underlying corporation. These income trusts are not subject to corporate law, and provide a unique opportunity to investigate what charter provisions, and what degree of liability for directors, is chosen when the usual corporate law rules do not apply. There is evidence that most income trusts adopted some version of the duty of loyalty. *See* Anita Anand and Edward Iacobucci, *Contractual Freedom and Innovation in the Income Trust Market* (2006) (working paper, on file with Bernard Black). In late 2006, the government announced plans to remove the tax advantages of the income trust.

> Information shall constitute an employment or commercial secret in the event that the information has actual or potential commercial value due to the fact that it is not known by any third party, no legal basis exists to provide free access to it, and the proprietor of the information has taken measures to protect its confidentiality.

At the same time, the law has specified types of information which are not employment or commercial secrets. Thus, for example, the following are not employment secrets: the founding documents of a legal entity, information on the assets of government enterprises, information on which persons have the right to act on behalf of a legal entity without a power of attorney, etc. Russian legislation lacks criteria for determining when information is an employment secret, versus a commercial secret.

The only liability specified in Civil Code art. 139 and Law on Commercial Secrets art. 10 with regard to employment or commercial secrets is that persons who obtain these secrets by "illegal methods" are liable to the company for damages. The liability of the person who disclosed the information is not clear. Thus, the only clear way for a company to hold members of a company's management organs liable for disclosing confidential information would be to sign agreements with them on the non-disclosure of such information, which provide a damages or other remedy for breach. In practice, serious difficulties arise in determining the amount of damages, because the value of the divulged information is extremely difficult to calculate.

The Law on the Securities Market also contains some provisions on use of a company's internal information; for example, persons possessing this do not have the right to use it to conclude transactions with a third party (Law on the Securities Market art. 33). The Law on the Securities Market provides a definition of internal information which differs from the definition of employment and commercial secrets found in Civil Code art. 139. Both definitions, however, include the criteria of the lack of a legal basis for providing free access to the information and the proprietor's adoption of measures to protect the confidentiality of the information. Thus, unless a company adopts measures to protect the confidentiality of its internal information, it will not be able to hold a member of its management organs liable for disclosing this information.

It is unclear whether fault is a condition for civil liability for disclosure of employment or commercial secrets. One could interpret Law on Commercial Secrets art. 12(6) as not requiring fault for civil, as opposed to criminal liability for breach of confidentiality.

In sum, not many additional grounds exist for liability of the members of management organs, beyond those specified in the JSC Law and discussed above, and any grounds specified in a contract between a member of the executive organ and the company.

Canada

Analytically, directors' duties can be thought of as "gap fillers" parties would contract for under ideal market conditions. Practically speaking, however, in Canada the duties are rarely thought about in contractual terms. Instead, parties accept that directors have duties and obligations set down by statute and common law and rarely impose additional duties by contract. The duties imposed by corporate law are generally not subject to being overridden by a contract between the company and a director or officer, or by the corporate charter.[147]

Directors can face civil liability under a wide range of laws, not just corporate law. Securities law generates more concern for directors of public companies than corporate law because there is greater potential for direct suits by shareholders.[148]. The federal Income Tax Act § 227.1, in essence imposes a duty on directors to act with reasonable prudence to prevent failures by their companies to remit tax due. There apparently have been a significant number of cases brought under this provision, though probably most are against directors of small companies.[149] Whether large numbers of directors have been held liable is unknown at present. Outright default on income tax obligations will be a rare occurrence for public companies, absent an abrupt financial collapse. Typically, large companies go bankrupt after a period of losses, which means they are unlikely to owe large income taxes.

Liability for unpaid wages is also a serious worry of directors. Under a combination of corporate law and employment law, directors of an insolvent company that fails to pay wages can be jointly and severally liable for up to six months of unpaid wages and related employment benefits (CBCA § 119, OBCA § 131). Though there has been much discussion of the risks that directors face, it does not appear that many suits are brought against directors, particularly of public companies. The small number of reported cases where directors have been held liable for unpaid wages have involved private companies.[150]

European Union

Duty of confidentiality

The statute governing the European Company (Societas Europaea, or SE) provides that the members of an SE company's management organs, including directors, are under a duty, not to divulge any information concerning the SE, disclosure of which might be against the company's interests, except where such disclosure is required or permitted under national law provisions applicable to public companies or is in the public interest.[151]

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147 CBCA § 132, OBCA § 132.

148 *See* Brian Cheffins and Bernard Black, *Outside Director Liability Across Countries*, 84 TEXAS LAW REVIEW 1385-1480 (2006), at http://ssrn.com/abstract=438321, at 1445-1447.

149 Martha O'Brien, *The Directors Duty of Care in Tax and Corporate Law*, 36 UNIVERSITY OF BRITISH COLUMBIA LAW REVIEW 673, 676 (2003).

150 *See, for example*, Can. Automatic Data Processing Serv. Ltd. v. CEEI Safety and Sec. Inc. [2004] 192 O.A.C. 152; Proulx v. Sahelian Goldfields Inc. [2001] 55 O.R.3d 775.

151 Council Regulation 2157/2001, article 49, 2002 O.J. (L294) 1 (EC).

France

General basis for liability

Directors' liability is based on law and not on contract. If a separate employment contract is validly concluded, its breach can also lead to liability. However, as far as we are aware, it is not typical for an employment contract to specify additional duties of directors similar to the fiduciary duties stated by law.

The question posed can be understood as asking whether directors may be willing to voluntarily opt into higher standards of liability. This can be indirectly observed, in the following sense. Corporate governance codes, such as those adopted in France and Germany, offer a way to voluntarily strengthen the governance structure of a particular company. This can also lead to higher standards of liability, because the nature of directors' duties is potentially flexible enough to take these commitments into account.

Duty of confidentiality

Directors of French companies are obliged to maintain confidentiality for the company's business information. Code de Commerce arts. L. 225-37(5), 225-92.

Germany

Directors' liability is based on the law. It is not possible to opt out of the liabilities imposed by law. It is of course theoretically possible to implement additional duties and bases for liability by contract, but this is not common practice.

With respect to additional sources of civil liability, AktG § 161, introduced in 2002, requires both the management board and the supervisory board of listed firms to annually issue a declaration whether the company complied with the German Code of Corporate Governance, and to state which of its provisions were not complied with. The directors may be liable if the company falsely declares that it has complied with particular provisions of the Corporate Governance Code. However, there are no cases under this provision, and it not clear how damages would be measured.

AktG § 93 III lists a number of specific situations where directors may be liable for breach of particular provisions of the law, for example, following the payment of unlawful dividends, the return to shareholder of their capital contributions, other than through a lawful dividend, the issuance of shares without full payment, and so on. The full list is as follows:

> (3) The members of the management board shall in particular be liable for damages if, contrary to this Act:
>
> 1. contributions are repaid to shareholders;
>
> 2. shareholders are paid interest or dividends;
>
> 3. company shares or shares of another company are subscribed, acquired, taken as a pledge or redeemed;
>
> 4. share certificates are issued before the par value or the higher issue price has been fully paid;
>
> 5. assets of the company are distributed;

6. payments are made after the company has been insolvent or overindebted;

7. remuneration is paid to members of the supervisory board;

8. credit is extended;

9. in connection with a conditional capital increase, new shares are issued other than for the specified purpose or prior to full payment of the consideration.

One can see this list as providing specific examples of actions which a reasonably diligent management director would not take, rather than imposing additional duties on directors.

Duty of confidentiality

Directors of German companies are obliged to maintain confidentiality for the company's business information. AktG § 93 I provides:

> [T]he members of the management board shall . . . not disclose confidential information and secrets of the company, in particular trade and business secrets, which have become known to them as a result of their service on the management board.

AktG § 116 extends this duty to members of the supervisory board.

Korea

Directors can potentially face civil liability under securities law. A director of a public company – either a representative director or an outside director who provides false or misleading statements or fails to indicate material concerns shall be liable to the party for any damages incurred as a result of such false statements or material omissions (KSEA art. 14). The directors have a due diligence defense, under which they will not be liable if they can show that they took reasonable steps to become informed and were not aware of the false statements or material omissions.

The controversial Securities Class Action Act (SCAA) came into effect in 2005 for companies with total assets of more than 2 trillion Korean won (roughly U.S. $ 2 billion), and will come into effect in 2007 for smaller companies. This Act provides an opportunity for class action lawsuits, which are otherwise not available in Korea, seeking damages as a result of false statements in a prospectus for a public offering of securities, annual, semiannual and quarterly reports, insider trading, stock price manipulation, and faulty auditing.

In 2003, the KSEA was amended to introduce a requirement for certification of a company's financial statements by the CEO and the Chief Financial Officer, similar to one of the requirements of the Sarbanes Oxley Act in the United States The representative director or other relevant officers are obliged to confirm and sign the disclosure documents, including registration statements and annual, semi-annual and quarterly reports.[152]

152 KSEA art. 8 ¶. 4, art. 14, ¶ 1, No.1-2.

United Kingdom

Directors' duties in English law are a mandatory minimum standard expected from directors. A particular company can, in its charter or through contracts with directors, agree with the directors on a higher standard of duty but not a lower standard. Companies Act 1985, §§ 309A-309C (replaced by Companies Act 2006, § 180) prohibit companies from reducing directors' duties below the level established by law.

In practice, companies do not seek to impose additional liability on directors. Recent legislative changes have moved in the other direction, by clarifying and expanding the power of companies to indemnify directors against legal expenses if they are sued.[153]

There are various sources of civil liability for directors other than company law. Some of the more important can be summarized briefly. Under securities regulation, directors of U.K. public companies can be held liable to shareholders if the offering documents circulated in support of a public offering of securities fail to include required material or contain false or misleading disclosures.[154] Negligent misstatements in the annual accounts and other documents disseminated by directors of a U.K. public company can in theory form the basis for a suit by investors.

Directors can also be held liable under tax law, employment law, tort law and for breach of contract. We discuss employment contracts and contracts for services below.

United States

Imposition of additional duties by contract

In theory, the duties established by corporate law could be increased in a company's charter or through a contract between a company and its directors. In practice, the imposition of additional liability in this manner is unknown, and most companies limit the liability imposed by the law, to the extent permitted by law.

The United States is unique among the comparison countries in having a large number of lawsuits against directors. Due to the frequency of lawsuits, the United States is also unique in allowing companies to limit the monetary liability of outside directors in their charters. With regard to breach of the duty of care, a company may limit or eliminate the monetary liability of outside directors, as long as the directors have acted in good faith.[155]

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153 These changes, and the *Equitable Life* lawsuit against outside directors, which produced pressure for these changes, are discussed in Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEXAS LAW REVIEW 1385-1480 (2006), at 1406-1415, at http://ssrn.com/abstract=438321.

154 Financial Services and Markets Act 2000 § 90 (United Kingdom); Al-Nakib Invs. (Jersey) Ltd. v. Longcroft [1990] 3 All E.R. 321.

155 DELAWARE CODE ANNOTATED title 8, § 102(b)(7) (2007); MODEL. BUSINESS CORPORATION ACT § 2.02(b)(4) (1984). *See also In re The Walt Disney Co. Derivative Litigation*, 906 A.2nd 27, 62-68 (Del. 2006) (discussing the meaning of the good faith exception), affirmed by the Delaware Supreme Court, 906 A.2nd.27 (2006).

This power to reduce directors' financial liability does not apply to officers, or to officers who are also directors when they act in their capacity as officers. A court can still award other remedies for breach of the duty of care, including an order to correct a violation. The power to reduce or eliminate outside directors' liability for monetary damages does not apply to the duty of loyalty, and thus provides no protection against lawsuits based on conflict-of-interest transactions between a company and its directors. However, for breach of the duty of care by outside directors, the law of Delaware and most other states allows reduction or elimination of monetary liability. In response, almost all public companies have eliminated all monetary liability of outside directors for breach of the duty of care.

Other fiduciary obligations under corporate law

Directors are subject to a duty of candor in their communications with shareholders. This can be seen as separate from the duty of care and duty of loyalty, although the courts treat it as encompassed by these more traditional duties.[156] Directors can be seen as subject to a heightened duty of care when their firm receives a takeover bid from another firm. The courts have treated this heightened duty as a combination of the traditional duties of care and loyalty.[157]

Civil liability under other sources of law

There are a number of other potential sources of liability for directors of public companies. First, company officers are responsible for complying with a wide variety of laws, including environmental, employment, and workplace safety laws. While the company will be the principal liable party if these laws are violated, officers of the company could potentially be secondarily liable and might have to pay damages if the company becomes insolvent.

Under some of these laws, it might be possible for outside directors to be liable as well, if they were aware of the problems and took no action. In practice, we are not aware of instances in which outside directors have been found liable under these laws.

Directors of public companies are potentially liable to shareholders for false and misleading statements in prospectuses for public offerings of securities or in a company's public financial reports and press releases. In practice, this is the most important source of liability for directors and officers, and far exceeds corporate law in its practical importance. In part, this is because of the strong protections that directors enjoy against liability under corporate law for conduct not involving a conflict of interest, due to a combination of the business judgment rule defense to liability under the duty of care, and the common practice of eliminating all monetary liability of outside directors for breach of the duty of care, so long as they have acted in good faith.

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156 *See* Malpiede v. Townson, 780 A.2nd 1075, 1086 (Del. 2001) ("[T]he boards fiduciary duty of disclosure . . . is not an independent dut[y, but instead is] the application in a specific context of the boards fiduciary duties of care, good faith, and loyalty.").

157 The duties of directors of target companies are complex, and beyond the scope of this Report. *See* RONALD J. GILSON & BERNARD BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISTIONS 730-871 (2nd edition 1995).

The CEO and CFO are required by the Sarbanes Oxley Act to certify the accuracy of the company's financial statements and can potentially be liable if they negligently certify financial statements that later turn out to be incorrect.

Directors and officers face liability under pension law if their company has a pension plan that invests in the company's stock and the directors or officers are fiduciaries of the plan (the circumstances under which this is the case is a complex question that is beyond the scope of this Report) and are negligent in allowing the plan to invest in the company's shares at a time when the share price has been inflated by the distribution of false and misleading information to the market.[158]

Directors and officers of companies in particular industries, such as banking and insurance, may face additional liability under laws specific to those industries. These laws are beyond the scope of this Report.

In addition to liability for breach of fiduciary duty, directors can be liable for payment of improper dividends, or for actions that exceed their authority. In a recent case, for example, the directors of a company approved a decrease in the exercise price of stock options granted by the company, after the company's share price had fallen, even though the company's stock option plan did not permit this. They settled the suit by agreeing to increase the exercise price back to its original level; the one director who had already exercised the stock options returned to the company the profit he earned as a result.[159]

Summary and recommendations

The principal additional duties in the comparison countries, apart from the duty of care (reasonableness), the duty of loyalty (good faith), and the obligation to act in the interests of the company, are the duty of disclosure (discussed in subchapter 1.2 above), and duties that arise under other sources of law. Of particular relevance for directors are duties of disclosure under securities law. There are also duties of directors that can arise under specific laws that apply to particular industries, most commonly banking, insurance, and other financial sector industries, and under laws that are designed to protect employees or the general public, such as environmental law, workplace safety law, and labor law.

Minor sources of liability under company law

Directors can also be liable under company law if they exceed their powers, or declare an improper dividend (or an improper repurchase of shares). Russian company law contains similar provisions. These do not appear to be controversial and were not included in the specific topics to be addressed in this Report. We therefore do not offer recommendations with respect to these additional bases of liability under company law.

Duty of disclosure

We recommend adoption of a duty of disclosure under company law in subchapter 1.2 above.

158 *See* Bernard Black, Brian Cheffins and Michael Klausner, *Outside Director Liability*, 58 STANFORD LAW REVIEW 1055-1159 (2005), at 1135-1138 , *at* http://ssrn.com/abstract=894921.

159 This case is discussed in *id.* at 1071-1074.

Duty of confidentiality

We recommend an additional duty of company directors and managers, which is the duty of confidentiality as to the company's nonpublic business information, including its commercial secrets. Such a duty is expressly provided for in the laws of some of the comparison countries. It is apparently not controversial in other countries, and hence was not discussed in the expert reports. In the United States, for example, the duty to preserve confidentiality would be seen, in all likelihood, as falling under the general duty of loyalty, or perhaps the obligation to act in the interests of the company. If a director disclosed nonpublic business information in the belief that he was furthering the company's interests, and without gaining personal advantage, the United States would consider this conduct to implicate only the duty of care. But there is little case law on this topic, despite the general abundance of lawsuits under corporate law in the United States. The principal reason is that breaches of the duty of confidentiality are not common, and when they occur, are usually handled quietly.

We understand that the scope of the obligation of directors to preserve confidentiality as to the company's business information has been a difficult one in Russia. The problem is that while there is a general obligation to preserve the confidentiality of commercial secrets, the definition of commercial secrets consists of a list of specific types of information, and does not include all of the information that a company might want to keep as confidential.

Thus, we believe there is value in establishing a duty of directors and managers to maintain confidentiality as to the company's nonpublic business information. Here is a possible framing of such an obligation, for members of the board of directors. This duty, like the other duties discussed in subchapter 1.2, should apply to the members of the executive organ and to an individual manager, a managing organization, and the director or managers within the managing organization who are responsible for managing the company.

> A member of the board of directors shall preserve the confidentiality of the company's nonpublic information, if disclosure of this information could cause harm to the company's business, including its relationships and business dealings with customers and suppliers. This duty shall not prevent a director from informing appropriate government authorities about violations of law, or the potential for future violations of law, by the company or its employees, or providing public disclosure about these violations or possible violations.

Duty of company managers to provide information to the board of directors

A recurring problem for non-executive directors in some Russian companies involves the need for all members of the board of directors, especially non-executive directors, to have access to the information and advice they need to do their jobs properly. One issue involves the failure of the managers of the company to provide even the basic information needed for the directors to meet their obligation to be reasonably informed. There are also instances in which directors may ask for additional information, not directly related to a decision to be adopted by the board. Within reason, company managers should be required to provide this information.

To address these problems, we recommend that the executive organ of the company be required to provide to the board of directors all important information needed by the board to adopt decisions on matters brought to the board for decision. While there may be exceptions where it is not feasible to provide information prior to a board meeting, in general this information should be provided before the meeting, so that the directors can review it prior to the meeting. We recommend that it should be a breach of the duty of good faith for a member of the company's executive organ to knowingly (zavedomo znaya) provide false, incomplete, or misleading information to the board of directors.

We also recommend that the executive organ should be required to provide to the members of the board of directors any other information which they reasonably request.

When the board of directors must adopt a decision on a reorganization, a major transaction, or a transaction in which an interest exists, the members of the board of directors should have the right to obtain the advice of counsel, at the expense of the company. If counsel for the company is doing its job properly, the board of directors will usually not need separate counsel. However, the members of the board of directors should have the right to obtain separate counsel if they believe this will assist them in doing their jobs properly.

Liability under other sources of law

For the most part, we treat the topic of duties under securities law, banking law, environmental law, and so on as beyond the scope of this Report. One particular point deserves mention, however. It is common, in a number of the comparison countries, to establish some obligation for directors and managers to review the company's financial statements and other official disclosure documents provided to shareholders and investors, such as annual reports to shareholders.

In connection with a public offering of securities, it is also common to establish liability of the members of the board of directors for misstatements or omissions on the disclosure documents related to the offering, if the directors knew or should have known about the misstatements or omissions, and remained silent instead of insisting on a correction. The degree of neglect needed to establish liability varies. One possibility is liability only if the director knew about the misstatement or omission. Another is liability for gross negligence. Another is liability for simple negligence. Still another is to place the burden of proof on a director, to show that the director did not know, or was not grossly negligent (or negligent) in not knowing, about the disclosure deficiencies, and that the director has exercised reasonable care in reviewing the disclosure documents (sometimes called "due diligence").

We recommend that all directors, including non-executive directors, be responsible for reviewing a prospectus for a public offering of shares, as part of their general duties, and providing comments to the persons directly responsible for preparing the documents if they have concerns with the disclosure. The burden of proof should be on the plaintiff in a lawsuit under the securities law to show that there were material misstatements or omissions in the prospectus. If the plaintiff does so, a director who served on the board at the time of the offering should have the burden of establishing that they conducted such a review. For a non-executive director, this can simply involve reading the prospectus, keeping in mind the director's prior knowledge of the company. If a non-executive director establishes his due diligence, we recommend that the plaintiff should then be required to show that the director was grossly negligent in not noticing the disclosure deficiencies.

Executive directors and senior managers are likely to have much better information about the company's business. Thus, a lower standard of liability, such as negligence, may be appropriate, or else a switch of the burden of proof. We recommend that an executive director or senior manager should be required to show that he was *not* grossly negligent.

These rules would supplement the current rules contained in the Law on the Capital Market, under which the only liable parties for misstatements in public disclosure documents are the general director and, for the financial statements, the chief accountant.

Subchapter 1.7. Damages for breach of duty

What should be the measure of damages for breach of duty under company law by directors, managers, or controlling shareholders? How should one measure damages for breach of duty?

General comment

The usual measure of damages is loss suffered by the injured party. The discussion below assumes that this usual measure will apply, and discusses primarily which additional remedies may be available. With specific regard to conflict-of-interest transactions, voidability of the transaction is also a common remedy. This remedy is discussed above, as part of the general discussion of these transactions. We discuss here principally the amount of damages or other monetary liability. We do not discuss statutes of limitation or other procedural rules.

Russian context

The amount of damages for which a member of a company's management organs is liable depends on the nature of the legal relations between this person and the company. Russian law distinguishes between liability under civil law and liability under labor law. Civil liability compensates the aggrieved party for all losses it has borne, both actual losses and lost profit. In contrast, labor liability generally covers only "real damages", which are limited to actual losses and do not include lost profit.[160]

Liability of the General Director

Under Labor Code art. 277, the single-person executive organ of a company is liable for "direct real damages" to the organization.[161] The definition of "direct damages" in Labor Code art. 238 corresponds to the definition of real damages under Civil Code art. 15.

160 We discuss the differences between civil liability and labor liability in Chapter 4.

161 Under Labor Code article 281, these liability provisions can extend to the members of the collegial executive organ if this is provided for in federal laws or the company's charter.

However, civil liability is based on the broader concept of losses, also contained in Civil Code art. 15.

In cases stipulated by federal law, the scope of damages for which the general director of a company can be liable is determined in accordance with the norms of civil law, rather than labor law. These cases include the liability of members of a company's management organs under JSC Law art. 71 and Law on Trade Secrets art. 11. Thus, the JSC Law and the Civil Code, rather than the Labor Code, should determine the amount of liability of a company’s single-person executive organ. However, judicial practice varies. In part, this is because the provisions of labor and civil legislation are not entirely consistent, thereby allowing for differing interpretations. In part, this may reflect judges' greater familiarity with the Labor Code than with the JSC Law.

Liability of Members of a Company’s Management Organs

Under Civil Code art. 15, a person is entitled to full compensation for losses he has incurred. In Russian civil law, the concept of “full compensation for losses” comprises two elements:

1. Real damages -- expenses which a person has undertaken or will need to undertake to restore his violated right, plus any loss or damage to his property,
2. Lost profit -- uncollected income which this person would have received if the norms of civil law had been complied with.

Moreover, damages should in any case be no less than the income received by the person who violated another person's right.

The provisions of JSC Law art. 71 on the amount of liability of persons who are members of management organs differ from the norms codified in Civil Code arts. 15 and 53. First, unlike the Civil Code, the JSC Law does not expressly allow members of management organs to limit the scope of damages by a contract with the company. The question remains open whether a different amount of liability, compared to that in the JSC Law, can be stipulated by a contract between a company and a member of the executive organ. Can a contract limit the maximum liability of a general director or establish additional punitive sanctions against him?

In determining the bases and amount of liability of members of a company's management organs, the usual terms of business dealings and other circumstances having importance for the case must be taken into account (JSC Law art. 71(3)). Widespread opinion exists that the members of management organs should not be held liable for business decisions which result in losses for the company. Instead, such members should be held liable for business decisions only if it is proven that their decisions were directly aimed at causing losses to the company. Otherwise, it is argued, if members of management organs are held liable for typical entrepreneurial decisions -- including risky ones -- that appeared rational in the company's particular situation, the company's operations will be severely hampered.[162] This interpretation, however, contradicts JSC Law art. 71(2), which states that all losses (independent of the circumstances) due to a breach of the duty to act

162 *See* M. V. Telyunika, *The Approval of Transactions Involving Individual Interest*, 3 ARBITRAZH PRACTICE (2005a) (М.В. Телюкина, *Одобрение заинтересованных сделок*, АРБИТРАЖНАЯ ПРАКТИКА).

reasonably, in good faith, and in the company's interests are subject to compensation. In our view, the JSC Law should instead provide that the usual terms of business dealings should be taken into account not in determining the bases and amount of liability of the general director, but instead in determining "whether he conducted himself reasonably and in good faith and whether or not fault was present in his actions".[163]

Legal practice has shown that when the company seeks compensation for losses, this is most often from a single-person executive organ,[164] and the losses most often arise as a result of transactions entered into with a third party (e.g., the lease of a building or the sale of the company's assets on terms unfavorable to the company, unlawful use of the company's assets by the single-person executive organ, etc.).[165] Less often the executive organ is held liable for inaction, for example in failing to timely pay taxes or make lease payments, as a consequence of which the organization loses property or suffers fines.[166] Even less often, the members of the board of directors or a managing organization are held liable.[167]

Canada

The usual measure of damages is loss suffered by the injured party. As discussed above, for a conflict-of-interest transaction, if a director fails to comply with the statutory provisions the contract will be voidable at the instance of the company (CBCA § 120(8), OBCA § 132(9)). The company or a minority shareholder can also apply for an order requiring the director to return to the company the profits received or gain realized. The

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163 A. A. Makovskaya, *Liability of the General Directors of a Joint-Stock Company*, RUSSIAN ROUNDTABLE ON CORPORATE GOVERNANCE (June 2-3, 2005) (А.А.Маковская *Ответственность руководителей акционерного общества*, КРУГЛЫЙ СТОЛ РОССИИ ПО КОРПОРАТИВНОМУ УПРАВЛЕНИЮ от 2-3 июня 2005 г), at http://www.oecd.org/data oecd/62/32/35174786.pdf.

164 *See* Determination of the Supreme Court of the Russian Federation No. 14-V01-31 (May 30, 2002) (Определение Верховного Суда Российской Федерации от 30 мая 2002 года N 14-В01-31); Decision of the Federal Arbitrazh Court of the Ural District No. F09-703/06-S5 (Feb. 16, 2006) (Постановление Федерального Арбитражного Суда Уральского Округа от 16 февраля 2006 г. N Ф09-703/06-С5); Decision of the Federal Arbitrazh Court of the Central District No. A08-5583/03-4 (Feb. 13, 2004) (Постановление Федерального Арбитражного Суда Центрального Округа от 13 февраля 2004 г. N А08-5583/03-4); Decision of the Federal Arbitrazh Court of the Central District, No. A09-7324/04-10 (Jun. 13, 2006) (Постановление Федерального Арбитражного Суда Центрального Округа от 13 июня 2006 г. N А09-7324/04-10).

165 *See* Decision of the Federal Arbitrazh Court of the Ural District No. F09-703/06-S5 (Feb. 16, 2006) (Постановление Федерального Арбитражного Суда Уральского Округа от 16 февраля 2006 г. N Ф09-703/06-С5); Decision of the Federal Arbitrazh Court of the Ural District No. F09-1180/03-GK (Dec. 24, 2003) (Постановление Федерального Арбитражного Суда Уральского Округа от 24 декабря 2003 г. N Ф09-1180/03-ГК); Decision of the Federal Arbitrazh Court of the Ural District, No. F09-1180/03-GK (May 7, 2003) (Постановление Федерального Арбитражного Суда Уральского Округа от 7 мая 2003 г. N Ф09-1180/03-ГК).

166 *See,* Determination of the Supreme Court of the Russian Federation, No. 14-V01-31 (May 30, 2002) (Определение Верховного Суда Российской Федерации от 30 мая 2002 года, N 14-В01-31).

167 *See,* Decision of the Federal Arbitrazh Court of the Central District No. A68-200/GP-16-05 (Jan. 24, 2006) (Постановление Федерального Арбитражного Суда Центрального Округа от 24 января 2006 г. N А68-200/ГП-16-05).

wording of the OBCA appears to leave open the possibility that the corporation could sue for damages rather than a return of profits. The CBCA appears to restrict the remedies to setting aside the contract or an accounting for profits.

The case in which a director or officer takes personal advantage of a business opportunity that was also available to the corporation is another area where remedies can be an issue. If a director improperly exploits personally a business opportunity in which the company potentially had an interest, the company can seek a return of the director's profits even if the company likely would not have been able to exploit the opportunity itself.[168] The company can probably also seek compensation for losses (including loss of prospective profits from taking advantage of the opportunity.)

There are no Canadian cases where judges have considered with care how directors' profits should be measured. If the issue were to arise in the future, the Canadian courts would likely treat English case law as relevant precedent.[169] Similarly, there are no Canadian corporate opportunity cases where a court has awarded compensation for losses suffered rather than a return of profits. If this issue were to arise in the future, again the Canadian courts would likely treat case law from other Commonwealth countries as relevant precedent.[170]

France

Directors are liable for damages caused to the company due to breach of fiduciary duty. It does not appear that directors would also have to disgorge their profits, in the case of a conflict-of-interest transaction

The company has the right to seek cancellation of a conflict-of-interest transaction, but must show that the transaction has "prejudicial consequences for the company" (Code de Commerce, art. L. 225-42). These sanctions may appear weak, but are supplemented by the potential for criminal liability (Code de Commerce, art. L. 242-6 (no.3)). We discuss criminal liability below.

Germany

The standard remedy for a breach of fiduciary duty is damages incurred by the company (AktG § 93). General principles of German private law suggest that disgorgement of profits can also be a possible remedy in some cases. For instance, it may be the case that damages are assessed in a "normative" way, in order to protect integrity and morality, in measuring the proper amount of damages. This general principal could permit an argument that profits from a conflict-of-interest transaction that was completed without proper approval by the company should be returned to the company. Another possible basis for a remedy of disgorgement of profits is if they are based on "spurious"

168 *See, for example*, Can. Aero Serv. Ltd. v. OMalley [1974] R.C.S. 592.

169 *See, for example*, Ultraframe (United Kingdom) v. Fielding [2005] E.W.H.C. 1638.

170 *See*, *for example*, Warman Intl v. Dwyer [1995] 182 C.L.R. 544 (Austl.).

enrichment under German Civil Code § 687(2) or unjustified enrichment arising from invasion of another's right under German Civil Code § 812(1).[171]

Under company law, there is also a special case where a disgorgement of profits can be the remedy: under AktG § 88 I, members of the management board may not set up a business or engage in any business transactions in the firm's industry without approval by the supervisory board. Furthermore, a member of the management board may not be a partner or a manager in any other business enterprise, regardless of its line of business, without approval by the supervisory board. Members of the management board who violate this duty are subject to claims for damages suffered by the company. Alternatively, the company may require the manager to treat any transactions completed in violation of this duty as having been entered into on account of the company, which effectively means that the profits from these transactions must be paid to the company. The firm may also require the manager to disgorge any compensation he received for this employment and to cede to the company any claims to compensation he may have as a result of this employment.

Italy

Under Italian law, the general remedy of damages is also the only remedy available for a breach of the duty not to compete with the company (Italian Civil Code § 2390). This contrasts with the additional remedies available for a similar breach under German law. Damages are also the general remedy for breach of duty under company law (Italian Civil Code § 2393). In conflict of interest transactions the damage also includes the loss of business opportunity (Italian Civil Code § 2392(5)).

Korea

The usual remedy for breach is damages suffered by the company. In practice, this issue is very important, because the Korean courts regularly dismiss claims for failure to prove damages, even if there has been a clear breach of duty by the defendant directors.

For the company to recover, it must prove that the director's breach of duty proximately caused the loss (Korean Civil Code art. 393). The Korean Supreme Court has ruled that the nature of the director's liability is similar to liability for breach of contract.[172] Therefore the contract law measure of damages, rather than the tort law measure, applies. This means, in practice, that the courts require a higher degree of certainty in assessing the amount of damages, and set a standard of proof that is often difficult to meet.

In the *Samsung Electronics* case, although the Seoul High Court accepted the plaintiff's claim that Samsung Electronics suffered a loss of 62.66 billion Korean won from the sale of certain shares, it opined that the directors' liability should be limited. According to the court it would be proper for the company and the directors to fairly apportion the loss

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171 *See* Mathias M. Siems, *Disgorgement of Profits for Breach of Contract: A Comparative Analysis*, 7 EDINBURGH LAW. REVIEW 27 (2003).

172 Case No. 84-Daka 1954 (June 25, 1985).

suffered by the company in connection with the directors' performance of their duties, in light of such factors as the type and size of business in which the company was engaged, the performance of the directors, and other circumstances. In this case, under the circumstances, the court viewed that it would be proper to limit the liability of the directors to 12 billion Korean won, approximately 20% of the loss suffered by Samsung Electronics. There was no statutory basis for this part of the decision, nor is it apparent from the decision why the court chose this amount of damages. The judgment seems to reflect the court's sense that to impose the full measure of damages (about U.S. $63 million) on the directors would be unfair, taking into account the severity of their breach of duty. This judgment has the flavor of the decision of "equity" jurisprudence in a common law country, in which the court seeks to obtain a fair result, and is not limited by strict rules on the elements of a cause of action or on the measure of damages.

United Kingdom

The usual remedy for breach of duty is either the damages suffered by the company or the profits made by the director who has breached his duty, but not both. A transaction with a company which involves a conflict of interest is voidable at the option of the company.[173] However, the company's right to avoid the transaction can be lost in a number of ways:

> (1) the company, by action of the board or directors or potentially by the shareholders, approves the transaction after full disclosure by the director;
>
> (2) undue delay;
>
> (3) inability of the court to restore the parties to their previous position;
>
> (4) harm to the rights of an independent third party if the transaction were to be unwound; or
>
> (5) if the counterparty to the transaction with the company is someone other than the director (for example, another company in which the director has an interest), the transaction will not be voidable if the counterparty can prove that it was "innocent" (it had no knowledge or notice of the conflict). In practice, however, this will normally involve showing the transaction was fair, as a court will be quick to infer from a transaction disadvantageous to the company that the counterparty was not "innocent", but seeking to exploit the company.[174]

If a company cannot avoid a transaction for reasons beyond its control (i.e., reasons (3)-(5) above) it can instead claim from the director, at the company's election, *either* the loss it suffered *or* the profit the director made.[175]

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173 Burland v. Earle, [1902] A.C. 83; *Re* Cape Breton Co. Ltd., (1885) 29 Ch.D. 795.

174 *See* Farrar v. Farrars, Ltd. [1888] 40 Ch. D. 395.

175 Tang Man Sit v. Capacious Invs., Ltd., [1996] 1 All E.R. 193.

Where a director takes advantage of a business opportunity that was also available to the company, the company may again elect to recover *either* the loss it suffered *or* the profit the director made, but not both.[176]

It is one thing to say a company may seek a recovery measured either by the losses caused to the company or the profits received by a director. It is quite another to measure and prove these losses or profits. Measuring losses is especially difficult. For the company to recover the loss, the company must show that the director's breach of duty *caused* the loss; and this is often difficult to prove. One common problem is that often the same loss might have happened anyway. For example, where a director takes advantage of a business opportunity that might have been available to the company, then the company has suffered loss only if it would have been able to exploit the opportunity profitably. This can be difficult to prove.[177]

For this very reason, companies most often elect to claim the director's profits. These are often easier to calculate, but proving the amount of the director's profits can also be difficult. The starting point is to show what profits (*i.e.*, receipts less expenditure) the director made which were made possible by his breach of duty.[178] It is up to the director to try to show why that figure should be reduced – for example, to allow for his effort in turning a mere business opportunity into an actual monetary profit. The director is initially presumed not to be entitled to such an allowance, due to his breach of duty, but has the opportunity to persuade the court otherwise).

The unfair prejudice cause of action discussed above has its own remedies. If this cause of action is employed in a situation involving a conflict of interest, these remedies are broadly similar to those discussed above. In general, transactions that violate a relevant provision can be undone, and directors will be liable, at the election of the company, either for losses caused to the company or profits made by them.

United States

For a violation of the duty of care, there is typically no profit earned by a director, so the measure of damages is loss suffered by the corporation. Recall, however, that it is extremely difficult to prove a breach of the duty of care, and that outside directors are usually not liable for monetary damages for breach of this duty. Thus, cases awarding damages are extremely rare. The last known case in Delaware was in 1985, and this case

176 *See* the leading Australian case of Warman Intl v. Dwyer, [1995] 182 C.L.R. 544, 559 (Austl.). The *Warman* case, which drew on earlier English authorities, was applied by the English Court of Appeal in Murad v. Al-Saraj [2005] EWCA (Civ) 959.

177 *See, for example*, Gwembe Valley Dev. Co. v. Koshy (No. 3) [2003] EWCA (Civ) 1048.

178 The difficulties in making even these calculations are illustrated by several recent cases. *See, for example*, Murad v. Al-Saraj [2005] EWCA Civ 959; Ultraframe (UK) Ltd. v. Fielding [2005] EWHC 1638 (Ch).

led directly to the amendment to the law to permit companies to eliminate the monetary liability of outside directors for breach of the duty of care.[179]

For a violation of the duty of loyalty, the most common basis for a lawsuit is a conflict-of-interest transaction entered into by the company. In this situation, the court has wide discretion in deciding on an appropriate remedy. The available remedies include:

- losses suffered by the company, including lost profits
- return of any profit earned by the director;
- reversal of the transaction, when reversal is still a practical possibility; and
- "rescissionary damages", measured as the difference between the outcome the company would have received if the transaction had not taken place and the actual outcome.

For violation of the duty of disclosure, the remedy is not clear, for lack of decided cases. Most cases involving failure of disclosure are brought under securities law, not under corporate law. The measure of damages under securities law, generally speaking, is the loss suffered by a shareholder who relied (or is assumed to have relied) on false or misleading disclosure, relative to the outcome the shareholder would have received had the shareholder made other similar investments in the stock market which were not affected by false or misleading disclosure.

Summary and recommendations

In the case where a director breaches a duty to the company, but does not directly or indirectly realize any personal profit, the only realistic measure of damages is the harm suffered by the company. As several of the commentaries suggest, while this measure of damages is commonplace, harm to the company can also be hard to prove. Unfortunately, we know of no escape from this problem. The definition of damages under the Russian Civil Code and the JSC Law (*ubouytki* in most cases) is appropriate.

In a situation involving a conflict of interest, in which a director directly or indirectly, realizes a personal profit, the company should be able to obtain the greater of the harm caused to the company, or the profit earned by the director and his affiliated persons. Often, the amount of profit will be easier to prove than the harm to the company. Often, too, the amount of profit will be larger. A strict measure of damages is appropriate to deter the completion of a conflict of interest transaction, without complying with a director's duty of good faith -- and often without complying with JSC Law ch. 11 as well, since this chapter will apply to many conflict-of-interest transactions. The concept of damages (ubuoytki), contained in Civil Code art. 15(2.2), includes profit to the person

179 The exceptional case is Smith v. Van Gorkom, 488 A.2nd 858 (Del. 1985). A recent extensive search for other cases in which outside directors paid damages under corporate law for breach of the duty of care found none, though the authors did not specifically search for cases in which there were monetary settlements paid for by insurance. Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STANFORD LAW REVIEW 1055-1159 (2005), *at* http://ssrn.com/abstract=894921.

who has violated a right as an alternate measure of damages. Thus, no change to the JSC Law is needed.

A further remedy for a conflict-of-interest transaction, completed in violation of a director's duty of good faith, is to consider the transaction voidable at the election of the company. This is the approach taken in some of the comparison countries, and also in JSC Law chapter 11. Although this remedy is not directly available for breach of duty under JSC Law art. 71, it is likely to be available in practice. A director who breaches the duty of good faith under JSC Law art. 71 will also, in most cases, have violated the provisions of JSC Law ch. 11, which specify disclosure and approval procedures for transactions in which an interest exists. The remedies specified in JSC Law ch. 84 for violation of these provisions include voidability of the transaction.

We do, however, recommend amending JSC Law art. 84 to provide that the courts should invalidate a transaction if reversal of the transaction will not cause harm to third parties. A similar restriction should be included in JSC Law art. 79 (remedies for breach of JSC Law ch. 10, covering major transactions).

When more than one remedy is available, the plaintiff should be able to elect among these remedies, subject to the discretion of the court with regard to reversal of a transaction, since reversal may not be possible or may cause harm to third parties. This is the current practice under Russian law, so no change is recommended.

Often, if one director has breached a duty to the company, others will have done so as well, due to the collective nature of many of the actions by the board of directors. In this instance, the usual rule is joint and several liability. This is the rule provided for in JSC Law arts. 71, 84. We do not recommend changing these provisions.

Although we have discussed only the damages remedy for directors, we recommend that the same measure of damages, and the same alternative remedy of voidability for a conflict of interest transaction should be available for a breach of duty owed to the company by other persons, including members of the company's executive organ and controlling shareholders.

Chapter 2. Legal nature of relationship between a director and a company

Issue: *Should the relationship between a company and a member of the board of directors be governed by contract or by the JSC Law? In particular, should compensation be paid on the basis of a contract with the company, or a decision by a general meeting of shareholders?*

General comment

This chapter will distinguish between a director who is a full-time employee of the company, and an "outside" director, who is not a full-time employee. In most cases, in most countries, a director who is a full-time employee will enter into a contract with the company, even when this is not required by law. There is more variation for outside directors.

Russian context

General provisions on the legal status of directors

In practice, board members are divided into executive, non-executive, and independent.[180] Russian legislation does not differentiate between the legal status of an executive and a non-executive director, and there are only limited differences between the powers of an independent and an executive/non-executive director.

The JSC Law employs the concept of an independent director only in connection with completion of self-interested transactions and in valuing assets of the company or a third party. If a company has more than 1,000 shareholders, JSC Law art. 83(3) requires that a self-interested transaction be approved by a majority vote of non-interested independent directors and specifies criteria which a director must satisfy to be considered to be independent. JSC Law art. 77(1) also assigns to the independent directors in specific cases the monetary valuation of assets involved in a transaction. In all other situations, the legal status of an independent director is the same as that of other directors.

The Code of Corporate Governance defines the concept of an "independent director," but is only advisory in nature, so its norms acquire legal force only if they are included into a company's charter or other internal documents. Under Code of Corporate Governance § 2, independent directors are those persons "who not only are not members of management, but are independent from the officers of the company, their affiliates, and major contract partners of the company, and who do not have any other relationship to the company which could influence the independence of their judgments."

Legal regulation of the relationship between a director and a company

Two controversial issues exist in this area of Russian law:

- Is the relationship between the company and a member of the board of directors regulated by the norms of civil law or labor law?[181]
- Does a contract or, instead, some other legal act serve as the basis for relationship between the company and a member of the company's board of directors?

In practice, independent directors often act without signing any contract with the company.[182] This practice finds its basis in the view that "all powers (and the obligations thereto pertaining) of a member of the board of directors are already written in the JSC Law, and there is thus no need to repeat them in a contract".[183] Moreover, the basis for

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180 See, for example, Russian Federation, Code of Corporate Conduct § 2.2.1 (2002) (Кодекс корпоративного поведения § 2.2.1).

181 We discuss this question in Chapter 4.

182 *The Practice of Selection and Compensation of Independent Directors in Russian Companies*, RESEARCH OF THE ASSOCIATION OF INDEPENDENT DIRECTORS (MFK, 2004) *(«Практика избрания и вознаграждения независимых директоров в российских компаниях»*, ИССЛЕДОВАНИЕ АССОЦИАЦИИ НЕЗАВИСИМЫХ ДИРЕКТОРОВ), at http://www.nccg.ru/site.xp/050056048052124.html.

183 B. R. KARABEL'NIKOV, LABOR RELATIONS IN ECONOMIC ENTITIES (FBK-Press, 2003) (Б.Р. КАРАБЕЛЬНИКОВ ТРУДОВЫЕ ОТНОШЕНИЯ В ХОЗЯЙСТВЕННЫХ ОБЩЕСТВАХ, ФБК-пресс).

payment of compensation to a member of the board of directors is a decision of the general shareholder meeting. The question remains, however, as to how the periods and procedure for payment of compensation are determined, as well as any bases on which the amount of compensation can be reduced. In practice, the procedure for payment of compensation to directors, the principal obligations of directors and other questions connected with the activities of directors are typically prescribed in the company's internal documents.

Another point of view is based on the fact that the relationship between the company and a member of the board of directors arises on the basis of decisions by the company.[184] Under Civil Code art. 8(1.8), civil rights and obligations can arise not only from transactions but also "as a result of other actions of citizens and legal entities." These other actions would include, for example, election of a person to the board of directors by a general shareholder meeting (JSC Law art. 48). By virtue of the decision adopted at the shareholder meeting, a person acquires the rights and obligations of a director. The same can be said of the payment of compensation to a director, which is also is carried out on the basis of the corresponding decision of a general shareholder meeting.

The difference between these two views has not been resolved in legislation, thereby leading to periodic legal conflicts. In our view, the relationship between a company and a director is by its nature contractual, as it represents two opposing wills directed at a single legal result. This contractual relationship is codified in various corporate acts in contrast to a single contract.

Canada

In considering director remuneration, it is important to distinguish between fees directors receive for services provided solely as a member of the board of directors and remuneration received by directors who also serve as executives. Executives commonly enter into managerial services contracts which specify their full remuneration. Corporate law does not require such a contract, but it is the customary practice.

We will therefore consider only directors who are not executives. In Canada, as with the UK, under old common law rules, established by court decisions, directors were not routinely entitled to compensation and did not have the authority to establish their own compensation.[185] Canadian corporate legislation now provides that the board of directors can decide on the remuneration of the corporation's directors and officers. Thus, the members of the board of directors can determine their own compensation. (CBCA § 125, OBCA § 137). It is possible for a company's charter to specify that the decision on compensation of directors and officers is to be taken by the general meeting of shareholders, but this occurs rarely, if ever, in practice.

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184 N. N. Pakhomova, *On the Legal Status of the Board of Directors (Supervisory Board) and Their Members in Economic Entities*, MODERN LAW, No 1 (2005) (Н.Н. Пахомова *О правовом статусе совета директоров (наблюдательного совета) и их членов в хозяйственных обществах*, СОВРЕМЕННОЕ ПРАВО); N. V. KOZLOVA, THE LEGAL PERSONALITY OF A LEGAL ENTITY (Statut Press, 2005) (Н.В. КОЗЛОВА ПРАВОСУБЪЕКТНОСТЬ ЮРИДИЧЕСКОГО ЛИЦА , Статут).

185 KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 762 (1999).

As a result, the primary constraints on the setting of compensation for directors and officers is that the directors must comply with their duty to act in the best interests of the company. The directors must also comply with any relevant procedural requirements set down in legislation and in the company's charter.[186] In addition, public companies must disclose the terms of executive compensation to shareholders under securities law.[187]

The compensation of directors may, or may not, be specified in a formal written contract between the company and the director. This varies between companies. However, even if there is not a written contract between the company and a director, the compensation is considered to be contractual in nature. That is, the director has a claim against the company for breach of contract if the compensation established by the board is not paid.

France

One-tier system

Outside directors

The procedure for compensation of directors is specified in French company law. The general meeting of shareholders determines the directors' compensation (Code de Commerce, art. L. 225-45). The board of directors may also reimburse a director for expenses related to company business (Code de Commerce, art. L. 225-46). The additional remuneration of the chairman of the board is determined by the board of directors (Code de Commerce, art. L. 225-47).

Article L. 225-44 of the Code de Commerce stipulates that apart from these provisions, and subject to the possibility of employment (which will be relevant for inside directors who are employed by the company, and is discussed below):

> "the directors may not receive any permanent or other remuneration from the company (…). Any clause to the contrary in the memorandum and articles of association shall be deemed null and void and any decision to the contrary shall be deemed null and void."

It follows that service contracts with outside directors are not possible. However, this does not exclude a separate contract based on the "professional activity" of a particular director. Thus, a director who also advises the company as a lawyer may be compensated for legal services.[188]

Inside directors

The remuneration of the CEO and the assistant general managers is determined by the board of directors (Code de Commerce, art. L. 225-53(3)). If the CEO or assistant general manager is also a member of the board, the aforementioned rules apply, which means that

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186 J. ANTHONY VANDUZER, THE LAW OF PARTNERSHIPS AND CORPORATIONS 238 (2nd edition, 2003); KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 763 (1999).

187 See Ontario Securities Commission Form 51-102F6, included in Ontario Securities Commission Rule 51-102, 25 Ontario Securities Commission Bulletin 718 (2002).

188 See FRANCIS LEFEBVRE, MEMENTO SOCIETES COMMERCIALES ¶ 8309 (2006).

service contracts are usually not possible. If the CEO or assistant general manager is not a member of the board of directors, the company may, but is not required to, enter into an employment contract with this person. We discuss these contracts in chapter 4.

Two-tier system

Supervisory board

If a French company has a two-tier board, the rules for compensation of the members of the supervisory board re similar to those for the members of a one-tier board. The general meeting of shareholders determines the remuneration of the board members (Code de Commerce, arts. L. 225-75, 225-83). Compensation for expenses is again possible (Code de Commerce, art. L. 225-84). Apart from these provisions and subject to the possibility of employment, which we discuss below, "members of the supervisory board shall not receive any remuneration, whether permanent or otherwise." (Code de Commerce, art. L. 225-85). Thus, service contracts are not possible.

Management board

The remuneration of the members of the management board is decided by the supervisory board (Code de Commerce, arts. L. 225-63, 225-59). French company law is silent on the possibility of service contracts, so separate service contracts may be valid. They are not required.

Germany

Members of the management board typically enter into a service contract with the company which specifies their remuneration. This is not expressly required by the German law on joint stock companies. However, the contractual nature of the relationship between a member of the management board and the company is implicit in AktG § 112, which states that the supervisory board represents the company vis-à-vis members of the management board. More generally, the position of a management director is seen as having a dual character. The director is a member of the management board, with powers and duties defined by law. He also has a service contract with the company, which is governed by general principles of civil law.

The service contract with a member of the management board is entered into by the supervisory board or a supervisory board committee.[189] Compensation must be reasonable in relation to the tasks of the board member and the company's situation (AktG § 87 I). In some cases, when a vacancy arises on the management board and filling it is urgent, the court may appoint a member of the management board. AktG § 85 I. In this case, this person is entitled to adequate compensation under AktG § 85 III.

It is unclear whether a third party, such as a parent company, may employ someone to act as a member of a company's management board. Such a contract may conflict with AktG § 76 I, which is interpreted to require the members of the management board to be independent of obligations to other companies. However, it is probably permissible if the

189 UWE HÜFFER, AKTIENGESETZ, § 84, ¶ 12 (7th edition, 2006).

company is formally part of a corporate group (AktG §§ 308 I, 323 I) and thus subject to instructions received from the parent.[190]

Supervisory board

Members of the supervisory board are permitted to receive compensation. This must be either specified in the company's charter or approved by a shareholder vote. The amount of compensation is usually determined by shareholders. The amount must be reasonable in relation to the tasks of the member and the company's situation (AktG § 113).

Members of the supervisory board (other than employee representatives) may *not* enter into employment relationships with the firm. Normally, they do not enter into service contracts with the firm, but may do so if they are given responsibilities beyond those generally specified by the company law. If such a service contract requires specialized knowledge or puts the member into a position of trust and confidence,[191] it must be approved by the remaining members of the supervisory board (AktG § 114 I). Otherwise, the service contract will be agreed on between the director and the management board, acting on behalf of the company.

Other matters

There are also special approval requirements for loans given by the firm to members of the management or supervisory board, or to close family members (AktG §§ 89, 115).

Korea

The KCC provides that remuneration for both executive and non-executive directors (including severance payments if a director is discharged) must be approved by a resolution of a shareholders' meeting unless otherwise specified in the company's charter (KCC art. 388). Generally, the shareholders will approve an overall amount for compensation of all directors, and the actual amount to be received by each director will be decided by the board.

Under the KSEA, public companies must disclose the total compensation paid to all directors in advance of the annual general meeting of shareholders. The compensation paid to each director is not required to be publicly disclosed. There are no comparable disclosure requirements for non-public companies.

The company is permitted to enter into compensation contracts with individual directors, and some companies do so, subject to approval of overall compensation by the shareholders. However, this is not the general practice. Increasingly, outside directors, especially foreign directors, wish to have an indemnification contract, so these contracts may become widespread over time, even though their legal validity remains uncertain. If the company grants stock options to directors, a stock option contract is required. To that extent, the directors' compensation is paid on the basis of a contract.

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190 UWE HÜFFER, AKTIENGESETZ, § 84, ¶ 14 (7th edition, 2006).

191 The term used by the statute is *Tätigkeiten höherer Art*, i.e. activity of superior type. The translation above reflects the predominant interpretation of the term. See UWE HÜFFER, AKTIENGESETZ, § 114, ¶ 3 (7th edition, 2006).

A 2003 Supreme Court decision (Case No. 2002-Da-64681) holds that a director's compensation is protected by the labor law if the substance of the director's work corresponds that of an employee of the company. The most important factor in the decision was whether the director worked under the instruction and supervision of the CEO, similar to an ordinary employee. It is unlikely that an outside director would fall in such a category.

There is otherwise no difference in the legal rules applicable to compensation of inside directors, who are employees of the company, and outside directors.

United Kingdom

Outside, or non-executive, directors

In England, the primary relationship between a company and an outside director is a matter of corporate law, but this relationship is often supplemented by contract. It is very common for outside directors of public companies to have a contract for services with the company. The UK Combined Code on Corporate Governance, § A.4.4 (2003 and 2006 editions) requires that the company have formal terms of engagement with an outside director. Those terms of engagement will, in English law, amount to a contract between the director and the company. A sample letter of engagement between a company and an outside director can be found at pp. 71-74 of the "Related Guidance and Good Practice Suggestions" annexed to the Combined Code (2003 edition).

Compliance with the Combined Code of Corporate Governance is policed under a "comply or explain why not" regime. In the case of a contract with an outside director, it is easier for most companies to comply than to explain why they did not do so, so contracts with outside directors have become the norm.

There is no requirement for the compensation of outside directors to be approved by shareholders. Thus, if there is a contract between a company and an outside director specifying remuneration, the contract will govern the position as regards remuneration. The sample letter of engagement between a company and an outside director included in the Combined Code includes a clause specifying the amount of compensation. This contract will be approved by the board of directors on behalf of the company.

If there is no contract between the company and a director, a director has only such right to remuneration as the charter confers: see *Guinness* v. *Saunders* [1990] 2 AC 663. However, it will be customary for a public company's charter to provide that the compensation of directors can be determined by the board of directors or, less commonly, by the shareholders.

Public companies must disclose the compensation of non-executive directors to shareholders (Companies Act 1985 §§ 234B-234C & Schedule 7A, replaced by Companies Act 2006, §§ 420-422 and implementing regulations yet to be drafted), though with less detail than is required for executive directors. Long-term contracts must be approved by shareholders (Companies Act 1985, § 319, replaced by Companies Act 2006, §188).

Inside, or executive, directors

It is customary for executive directors to enter into a contract with the company specifying the compensation for their services. Public companies must disclose the terms of executive compensation to shareholders (Companies Act 1985 §§ 234B-234C & Schedule 7A, replaced by Companies Act 2006, §§ 420-422 and implementing regulations to be drafted). However, this contract does not have to be approved by a shareholder meeting.

United States

In the United States, the board of directors determines the compensation of its own members. For public companies, the compensation of directors must be disclosed to shareholders annually in the notice for the annual shareholder meeting. There is no requirement for shareholder approval of the amount of compensation. The same rules govern inside, executive directors, and outside directors.

Many scholars think that it would be desirable for the law to require shareholder approval of the compensation of directors and senior executive officers, especially the CEO. It is believed that a requirement for shareholder approval might restrain the high levels of compensation paid to some executives.[192]

There is no legal requirement that the company enter into a contract with either outside directors or executives specifying their compensation. In practice, it is common for executives to enter into employment contracts, but not common for outside directors to do so. Outside directors may receive stock options, pursuant to a separate contract, and will often enter into a contract providing for indemnification by the company if the director is subject to a lawsuit as a result of his service as a director.

If an executive has an employment contract, the contract conveys no right to continued employment as an executive. Instead, the board of directors retains complete discretion to dismiss the executive at any time, for any reason. If the executive is dismissed, the employment contract conveys only the right to compensation.

Federal law restricts the amount and form of compensation. In particular, income tax law makes payments to executives above specified amounts non-deductible to the company, which discourages but does not prevent these payments. In particular, compensation that is not based on performance and exceeds $1 million per year is not deductible, and a severance payment that exceeds three times annual compensation is not deductible.

The Sarbanes-Oxley Act prohibits loans by public companies to their directors and officers. New York Stock Exchange listing rules require shareholder approval of the general terms of a stock option plan, including the overall number of shares that can be awarded, but do not require shareholder approval of the number of options to be granted to any one person or group of persons.

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192 See, for example, LUCIAN ARYE BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

If an executive is also a director, and is dismissed as an executive, he will ordinarily also resign from the company's board of directors, even though his term as a director has not yet expired. However, there is no legal requirement that he do so.

Summary and recommendations

The dominant approach in the comparison countries is to distinguish between the right to hold a particular position in the company's board of directors or management organ, which is determined by company law, and the compensation that a person is entitled to be paid, which in most countries is considered to be a matter of contract between the company and the person. The amount of compensation is sometimes specified in a service contract with the company. Company law, contract law, and employment law may all have provisions which are relevant to the terms of compensation, and company law will determine the manner in which the compensation contract is approved. However, the compensation itself, once approved, is a matter of contract.

Thus, in most countries, members of management serve at the discretion of the board of directors and can be dismissed at any time. Germany is an exception -- members of the management board serve for fixed terms and can be dismissed only for good cause. However, we do not recommend this approach, and believe instead that the board of directors should have the power to dismiss the members of the company's management organs at any time, for any reason.

In countries with a unified board, in which some members are also members of the board of directors, dismissal as a manager does not affect the person's position on the board of directors. Instead, the two posts are seen as separate. The board of directors can dismiss a person from a position as a manager; but only a general shareholder meeting can dismiss a person from a position as a director. We recommend this approach.

With regard to the amount of compensation to be paid to directors, including executive directors, practice varies. In some countries, this compensation is determined by the board of directors. In others, the board of directors can recommend the amount of compensation, but it must be approved by the general shareholder meeting. We recommend the second approach.

In Russia, shareholder approval of the compensation of directors is required under JSC Law art. 64. However, executive directors are treated as receiving two streams of compensation -- one amount as a director, approved by a general shareholder meeting, and a typically larger amount as an executive, approved by the board of directors under JSC Law art. 69. This is consistent with seeing an executive director as holding two separate positions.

At present, the board of directors of a Russian company typically has the power to appoint and dismiss only the CEO (if the company has an individual executive organ) or the members of the collegial executive organ, if this organ exists. No change is recommended to this provision.

Power of directors to resign; election of replacement directors

An important power of a director, especially a non-executive director, is the power to resign if the director becomes uncomfortable with the company's management, its business strategy, or the other members of the board of directors. Surprisingly, this right is not clear in Russia at present. It is not explicitly stated in the company law, and court practice varies. We therefore recommend that the JSC Law be amended to explicitly permit a member of the board of directors to resign his position at any time. A director who resigns would not, of course, receive compensation for the remainder of his term.

A related problem is that if a director dies, becomes disabled, or resigns, there is no clear procedure for the company to elect a replacement director, without holding a new election for the entire board of directors. We recommend that, in this situation, a general shareholder meeting has the power to elect a number of directors sufficient to replace the director(s) who have left the board, for the remainder of the term of the board as a whole.

Chapter 3. Liability rules for different members of company management organs

Should there be different liability rules for people holding different positions in a company? Should the duties of government-appointed directors be different than the duties of other directors?

General comment

With regard to whether different types of directors, should have different duties, or face different standards for when liability will be found for breach of duty, there are a number of distinct situations to be addressed:

- for a company with a unitary board, members of the board of directors who are also members of the management organ versus outside directors;
- for a company with a two-tier board, members of the management board versus members of the supervisory board;
- the chairman of the board of directors versus other directors (for companies with a non-executive chairman);
- members of particular committees of the board of directors, such as the audit committee or the compensation committee;
- members of a formal management organ (such as the German management board) versus other senior managers who are not members of this organ, and
- directors appointed by the government versus other directors.

For government-appointed directors, we will address the situation of a company whose shares are partly held by the government and partly by minority investors.

Audit committee

In most of the comparison countries, the unitary board or supervisory board of a public company must include an audit committee with particular responsibility for the company's financial statements. This committee is required for public companies, banks, and insurance companies by a European Union directive, which must be implemented by member states by June 2008.[193] It is required in the United States by stock exchange rules and by the Sarbanes Oxley Act. In Korea, an audit committee is required for banks and for large public companies (assets greater than 2 trillion Korean won, or about U.S. $ 2 billion).

Russian context

Civil Code art. 53 and JSC Law art. 71 contain unified norms of liability for all members of a company's management organs.[194] Thus, as a formal matter, the same norms apply to both executive and non-executive members of the board of directors, and the same norms apply to the individual executive organ, or the members of the collegial executive organ, as apply to directors. In practice, courts can interpret these norms differently as they pertain to the conduct of different members of a company's management organs.

One problem area involves directors who are appointed by the State. Under JSC Law art. 71(6), they have the same liability as other directors. This approach to the liability of state representatives, however, is problematic. Appointments to position on a company's board of directors can be made for State employees on the basis of a decision of the President of the Russian Federation or, for other citizens, on the basis of a contract on representation of the State's interests. A State representative must seek written approval from State bodies before voting as a member of a company's board of directors on specific important questions, specified in the decision appointing this person, or in the contract between the State and this person. If some of a company's -shares are held in federal possession, representatives of the Russian Federation in a company's management organs shall carry out their duties on the basis of written directives of the Federal Agency on the Management of Federal Assets.

Thus, in practice, a State representative, in adopting decisions as a member of the board of directors, does not express his own will but instead merely informs others of the will of the State. The director also acts in the interests of the State, rather than the interests of the company. It seems unjust and ineffective to hold such persons liable for decisions that they do not themselves adopt. Moreover, it will be practically impossible to hold liable a State representative who conveys a decision made by others, because one cannot prove either fault guilt or a lack of good faith on the part of the State representative. As a result, no one will be liable for decisions adopted by a State representative, whether or not these decisions advance the company's interests.

193 *See* Council Directive 2006/43/EC, arts. 22, 24, 2006 O.J. (L.157) 87-107 (EC).

194 We discuss these norms in Chapter 1.

Canada

Different types of directors

Canadian corporate law provides for a single, unitary board. As a result, there is no formal basis in statutory law for distinguishing between the liability rules applicable to different types of directors -- for example, between executive and non-executive directors. Court decisions interpreting the fiduciary duties of directors also have generally not established different standards of liability for persons in different positions, whether the difference in question is inside director versus outside director, chairman versus other directors, or committee members versus other directors.

Canadian corporate statutes typically require public companies to have a minimum number of outside or non-executive directors (three outside directors under CBCA § 102; one-third of the board under OBCA § 115). The relevant statutes do not distinguish in any way between the liability of outside directors and other directors.[195] Canadian corporate law explicitly authorizes the board to delegate some of its managerial duties to board committees and to a "managing director" (CBCA § 115, OBCA §127). The board will retain overall responsibility for managing the corporation, but the directors who have delegated these duties will, under normal circumstances, be entitled to rely on the persons with primary responsibility for these duties to carry out their duties honestly and responsibly.

Despite past trends, it is possible that in the future Canadian courts will begin to distinguish between different types of directors when ascertaining liability. In *Re Standard Trustco*, a 1992 decision of the Ontario Securities Commission (OSC) under securities law, the OSC implicitly acknowledged that a lesser degree of knowledge and diligence might be appropriate for outside directors, due to their part-time status, but said outside directors should question management sufficiently to oversee properly a company's operations and disclosure. The OSC also indicated that a company's chairman of the board and the members of its audit committee could bear greater responsibility than other directors. This was not because they were required to meet a higher legal standard but rather because they will have greater knowledge of a company's circumstances than other directors.

The CBCA contains a "due diligence" defense, which is available to directors who otherwise might be held liable for breaching statutory provisions regulating the payment of dividends and other specified transactions (CBCA § 123). A similar protection is also often available under other statutes, including tax law and employment law. Typically, when legislation provides a due diligence defense, a director or officer must show that he did not know of the breach by the company despite having been reasonably diligent in carrying out his duties, in order to avoid liability. One might expect, with support in at least one tax case, that executives will find it more difficult to rely on a due diligence defense than outside directors because the executives direct involvement in running the company will make it difficult for them to claim that they were not aware of the

195 KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 827 (1999).

company's lapse in compliance, despite reasonable diligence, because they will be expected to be familiar with the company.[196]

Government-appointed directors

Canadian corporate legislation does not contain special legal principles governing the duties of a government-appointed representative who is a director of a company which also has private shareholders. A government-appointed director would likely owe the corporation the same duties as other directors. This would be consistent with the general rule that a director nominated by a particular shareholder owes the same duties to the corporation as any other director.[197] However, there is no case specifically on point.

There is some case law suggesting judges are becoming more willing to recognize the commercial realities of life and permit a nominee director to protect the interests of those who have appointed him.[198] If this were to become the law, it also might provide some protection for a government-appointed director who acts in the interests of the government rather than in the interests of the company. Nevertheless, a director who is nominated by the government to serve on the board of a private corporation would be well advised to proceed very cautiously, and perhaps to resign if his obligation to the government appears to conflict with his obligation to the corporation.

France

One-tier board

The main provision on liability of directors, for a company with a one-tier board, is Code de Commerce art. L. 225-251, which states that:

> [T]he directors and the CEO shall be individually or jointly and severally liable to the company or third parties either for infringements of the laws or regulations applicable to public limited companies, or for breaches of the memorandum and articles of association, or for tortious or negligent acts of management. If more than one director, or more than one director and the CEO, have participated in the same acts, the Court shall determine the share to be contributed by each of them to the compensation awarded.

The wording of this rule does not distinguish between different types of directors, nor does it contain special rules for the CEO or for the chairman of the board. However, its application depends on the powers, duties, and nature of the corporate organ to which they apply. For instance, the *président directeur general* (PDG), who serves as both CEO and chairman, may bear responsibility for typical management errors.[199] The reference point for the standard of care applicable to a specific director standard is that of a director of the same category,[200] meaning in this instance other persons holding the position of

196 *See Soper v. R.* [1998] 1 F.C. 124 (Can).

197 *See, for example*, 820099 Ontario Inc. v. Harold Ballard Ltd. (1992) 3 B.L.R.2nd 113 (Ont. Div. Ct.).

198 KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 727 (1999).

199 FRANCIS LEFEBVRE, MEMENTO SOCIETES COMMERCIALES ¶ 8740 (2006).

200 YVES GUYON, DROIT DES AFFAIRES ¶ 459 (11th ed. 2001).

PDG. Other directors may not be held to the same standard of liability as the PDG. Conversely, an unpaid board member will typically be held to a less strict standard of care than a director who receives compensation.[201] It is unclear whether employee representatives on the board of directors are subject to the same standard of liability as directors elected by shareholders.[202]

For senior executives who are not members of the board of directors, such as assistant general managers, article L. 225-251 does not apply. Their liability is therefore based on the general liability rules established in the French Civil Code.[203]

Two-tier board

Under Code de Commerce art. L. 225-256, the liability of members of the management board is as stated in article L. 225-251, which is quoted above. The members of the supervisory board are subject to a narrower provision, under which they are not liable for acts of management. Code de Commerce art. L. 225-257 states:

> [M]embers of the supervisory board shall be liable for negligent or tortious acts committed by them in a personal capacity in the performance of their duties. *They shall incur no liability for acts of management or the result thereof.* They may be held liable in civil law for criminal offences committed by members of the management if, having been aware thereof, they did not report the said offences to the general meeting . . . .

Committees of the board of directors

The establishment of committees is recommended in the French Corporate Governance Code and almost all public companies have an audit committee and a compensation committee.[204] However, these committees have merely an advisory function. For instance, the French Supreme Court has held that the board of directors cannot delegate its power to determine the remuneration of executives to committees.[205] Due to this limited role of committees, the possibility of a different standard for liability of committee members has not yet become an issue in France.

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201 TERRE ET AL., LE DIRIGEANT DE SOCIETE: RISQUES & RESPONSABILITES ¶ 061-09 (2002).

202 *Compare* FRANCIS LEFEBVRE, MÉMENTO SOCIÉTÉS COMMERCIALES ¶ 8490 (2006) (stating that employee representatives are subject to the same standard) *with* YVES GUYON, DROIT DES AFFAIRES ¶ 459 (11th ed. 2001) (suggesting that one cannot require the same standard of a low-ranking employee with a seat on the board as one can for a representative elected by shareholders). However, employee representatives who sit on the board of public-sector companies are apparently subject to a relaxed standard of liability.

203 FRANCIS LEFEBVRE, MEMENTO SOCIETES COMMERCIALES ¶ 8824 (2006).

204 *Cf.* Sylvie Hebert, *Corporate Governance French Style*, 2004 JOURNAL OF BUSINESS LW, 656, at note 46. *See also* FRANCIS LEFEBVRE, MÉMENTO SOCIÉTÉS COMMERCIALES ¶ 8836 (2006) (tating that committees are often formed to comply with demands of foreign investors). As noted above, a new European Union Directive requires that a public company have an audit committee.

205 Cour de Cassation, Quot. Jul., 27 July 1995, p. 4.

Government-appointed directors

There is a general decree on public sector companies, which are the only companies which would be expected to have government representatives.[206] The relevant companies are explicitly mentioned in this decree. Under Article 5 of this decree, the board of directors or the supervisory board of these companies shall include members elected by the shareholders, and state representatives (the number of which is established by decree) and employee representatives. Under, Article 11 of the decree, state representatives do not receive any remuneration for their board membership, apart from their usual pay for government service. Under Article 22 of the decree, employee representatives also do not receive additional compensation. Furthermore, this article states that in determining the liability of employee representatives, the courts should take into account that they do not receive any compensation, and they should never be found to be jointly liable with directors who are elected by the shareholders.

One infers, from the explicit inclusion of special rules on the liability of employee representatives in the decree, and the absence of special rules on the liability of state representatives, that the ordinary rules of directors' liability apply to state representatives. Recall, however, that these general rules do permit the degree of care to vary depending on the position held by a director, and on whether or not the director receives compensation. These factors suggest that, if a case were to arise, the courts might apply a lesser standard of care to state representatives than to shareholder representatives.

In some public sector companies, state representatives have only a non-voting seat on the board. For example, the decree on the *Société Nationale Elf-Aquitaine*[207] stipulates in Article 2(1) that:

> [T]wo representatives of the State, appointed by decree, shall sit on the board of directors of the company, without entitlement to vote. One representative shall be appointed on a proposal by the Minister for Economic Affairs and the other on a proposal by the Minister for Energy.

Because these members of the board have no voting rights, as a formal matter they cannot affect the company's decisions and thus it is unclear whether they can be found liable for a breach of the duty of care. They could presumably still face liability if they are involved in a conflict-of-interest transaction. We are not aware of judicial decisions which assess the circumstances under which state representatives in public sector companies should be liable for breach of duty.

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206 Loi no 83-675 du 26 juillet 1983 relative à la démocratisation du secteur public (as amended). *See* also Dubois, *Rev. sociétés* 1986, 47 (responsabilité civile des diregeants des sociétés anonyme du secteur public).

207 Decree No. 93-1298 (Dec. 13, 1993). The European Court of Justice has held that the articles of this decree which relate to golden shares violate Article 56 of the European Treaty (freedom of capital). Case C-483/99, Commn v. France, 2002 E.C.R. I-4781. *See also* OXERA CONSULTING, SPECIAL RIGHTS OF PUBLIC AUTHORITIES IN PRIVATISED EU COMPANIES (2005) (report to European Commission), *at* http://ec.europa.eu/internal_market/capital/docs/2005_10_special_rights_full_report_en.pdf (discussing special rights of public authorities in privatized European Union companies).

Finally, there may be companies where the state is a controlling shareholder, but the company is not specifically covered by the decree on public sector companies. Here, as with other companies, the directors are elected by the general meeting and the general rules on directors' duties should apply.

Germany and Austria

Different types of directors

German joint stock companies have a two-tier board. However, the liability provision that governs members of the supervisory board simply refers to the liability provision that governs members of the management board. For supervisory directors, AktG § 116 I provides:

> Section 93 concerning the duty of care and responsibility of members of the management board applies correspondingly to the duty of care and responsibility of the members of the supervisory board.

There are no additional statutory rules, and there is apparently no case law in Germany addressing whether there should be differences in the standards of care applicable to management directors as compared to supervisory directors. However, there appears to be unanimous agreement in the literature that the duties of the members of the two boards are the same in principle, although they differ in practice due to the different tasks assigned by the law to the two boards. This can be paraphrased by saying that members of the supervisory board owe the duty of care and responsibility of an orderly "surveillant."[208] Presumably, the care required of supervisors, who are not full-time employees, is less than the care required of the full-time executives charged with managing the business. At the same time, according to the German Supreme Federal Court, every member of the supervisory board must have the ability to understand regularly occurring business transactions.[209] The same standard applies to shareholder and employee representatives on the supervisory board.[210]

With regard to differences between management directors and supervisory directors, the Austrian Supreme Court (OGH) has stated that the supervisory board's sphere of activity is smaller than that of management. The authority of the supervisory board is largely restricted to supervision of the management board, both as to past actions and expected future actions, the fulfilment of certain duties in the event of a financial or other crisis (such as putting pressure on managers to initiate insolvency proceedings), and review of financial statements. One can expect its members to spend a much smaller amount of

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208 Peter Doralt, *Haftung und Schadenersatz,* in ARBEITSHANDBUCH FÜR AUFSICHTSRATSMITGLIEDER, 721 (Johannes Semler editor, 1999), at 725.

209 BGHZ 85, 293, 295-296.

210 UWE HÜFFER, AKTIENGESETZ § 116, ¶ 2 (7th ed. 2006).

time.[211] At the same time, members of the supervisory board must be able to understand financial statements and the auditor's report.[212]

Within the supervisory board or the management board, there are no statutory rules concerning different standards of liability for directors with different tasks. In particular, there is apparently no difference in the standards applicable to the chairman of the supervisory board, as compared to other members of the supervisory board. However, individual supervisory board members may be held to a heightened duty of care if they were appointed because of specialized knowledge or abilities, for example if they are members of a specific profession[213] (for example, a certified public accountant).

With regard to the management board, where it is expected that certain tasks will be assigned to individual members, it is typically said that a residual duty to supervise remains with all of the members.[214] This same principle should apply to the supervisory board.

Committees of the Board of Directors

Members of committees of the supervisory board or the management board are generally considered to be subject to a heightened duty of care with respect to tasks within the authority of the committee.[215] The remaining members of the board presumably have a correspondingly lower duty, but this does not entirely relieve other directors from their responsibility to critically evaluate the outcome of the committee's deliberations.[216]

In Austria, the supervisory board of a public company must include an audit committee, which must include a member who is a "financial expert," and can be expected to have specialized knowledge in finance, accounting, and financial reporting. (Austrian AktG § 92(4a)). This is a new requirement, adapted from the similar requirement adopted for United States companies in the Sarbanes Oxley Act. It is not yet clear whether the financial expert will be subject to an increased duty of care when reviewing the company's financial statements.[217]

Managers who are not members of the management board are not normally discussed within the context of director's liability in Germany and are not subject to § 93.

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211 OGH 1 Ob 144/01k.

212 OGH 8 Ob 262/02s.

213 LG Hamburg, 2 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT UND INSOLVENZPRAXIS 194, 197 (1981).

214 *See, for example*, BGHZ 133, 370, 377-378; UWE HÜFFER, AKTIENGESETZ § 93, note 13a (7th ed. 2006).

215 Peter Doralt, *Haftung und Schadenersatz,* in ARBEITSHANDBUCH FÜR AUFSICHTSRATSMITGLIEDER, 721 (Johannes Semler editor, 1999), at 732.

216 *See* Johannes Semler, *in* 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ, § 116, ¶¶ 56-65 (Bruno Kropff and Johannes Semler editors, 2nd edition 2004).

217 As noted above, a new European Union Directive makes an audit committee mandatory for a public company.

Generally, their duties are determined by the contract of employment and by the general provisions of civil law. According to case law, employees will generally not be liable for the full amount of damages, and instead will be liable only in part, with the amount of liability depending on their degree of culpability (gross or slight negligence, with no liability for excusable mistakes), and general considerations of fairness (which include factors relating to the employee tasks, his family background, age, and so on).[218]

In Austria, similar rules have been codified in a special act which addresses the liability of employees who are not directors.[219] The act is commonly held not to apply to directors, because they are not considered employees.[220]

Government-appointed directors

Under § 4 I of the so-called *VW-Gesetz* (*Volkswagen* Act), each of the Federal Republic of and the State of Lower Saxony is entitled to appoint two members to the supervisory board of Volkswagen AG, as long as those political entities remain shareholders. However, there are no special provisions governing these directors' duties, so one may assume that their duties are the same as those of other members of the supervisory board.

There is an exception relating to directors' duty of confidentiality. Under AktG § 394, members of the supervisory board who were appointed or elected on behalf of a government authority (such as the federal or state government or a municipality) are not subject to the usual confidentiality restrictions that govern other directors, with regard to the reports they submit to that authority, assuming there is a legal basis for the reporting requirement. The exception does not cover business secrets that are not relevant to the purpose of the report. To compensate for this exemption, AktG § 395 provides that the government officials who receive these are subject to a duty of confidentiality covering the information they receive.

In Austria, the ÖIAG-Gesetz of 2000 provides that when vacancies arise in the supervisory board of ÖIAG (the parent company of Austria's nationalized industries, which now function as a privatization agency), the new directors are elected by the remaining board members in compliance with certain criteria stipulated by statute. Apparently, the idea is to allow ÖIAG to have a board that is relatively free of political influence, so that it can pursue privatization without constant political intervention. There are no special provisions on board members' duties or liability.

Korea (and a note on Japan)

Executive and non-executive directors

In Korea, executive directors and non-executive directors are generally subject to the same duties and potential liabilities. The Japanese Supreme Court, in its decision of May

218 *See, for example*, Stefan Edenfeld, in 1 ERMAN BÜRGERLICHES GESETZBUCH, § 610 ¶ 340 (Harm Peter Westermann editor, 11th edition 2004).

219 *Dienstnehmerhaftpflichtgesetz,* BGBl 1965/80, amended by BGBl 1983/169.

220 *See* Rudolf Strasser, *in* KOMMENTAR ZUM AKTIENGESETZ*,* §§ 77-84, ¶ 99 (Peter Jabornegg and Rudolf Strasser editors, 4th edition 2001-2006).

22, 1973, also ruled that there should not be different rules for executive directors and outside directors. However, according to the case law and leading scholarly opinions in Korea as well as in Japan, outside directors are subject to slightly reduced duties of care in monitoring the employees of the company.[221]

In contrast to the situation in the United States, where directors face similar duties as do officers who are not members of the board of directors, the liability rules established by Korean corporate law apply only to directors. As Korean companies have added outside directors to their boards, partly to meet legal requirements, more responsibility and authority is falling on officers who are not directors. The Korean government is considering expanding the coverage of the liability rules to include these officers through an amendment of the KCC.

At present, Korean companies have a unitary board structure, and there is no formal basis for a difference in the standard of liability for inside and outside directors. However, the proposed amendments to the KCC include an option to establish a two-tier board system, with a separate management board and supervisory board. If this proposal is enacted, the potential for members of the management board and members of the supervisory board to be subject to different fiduciary duties or different liability rules may become an issue.

Directors of financial institutions

Directors of financial institutions may be subject to a stricter liability regime. According to the Korean Supreme Court, the role of banks differs from that of other companies.[222] Banks are required to contribute to the stability of the financial markets and to the development of the national economy. Bank directors must fulfill their fiduciary duties with utmost (enhanced) care in (1) the protection of the properties of depositors; (2) the maintenance of credit systems; and (3) the promotion of efficiency in finance brokering. The court set out the following criteria by which the directors of the banks were to assess whether to grant loans: (1) the terms and conditions of the loan; (2) the loan amount; (3) the repayment plan; (4) the existence of collateral and its substance; (5) the status of the debtor's assets and business operations; and (6) the debtor's future business prospects. This ruling enhances the fiduciary duties of directors of financial institutions in Korea, compared to their counterparts in other companies, and instructs them that part of their task is to review the loans made by the bank.

Government representatives

Korea has a small number of partially privatized enterprises, which were formerly state-owned, in which the government still holds a significant share position. Special laws govern the conduct of directors of these state-owned enterprises. As far as the liabilities of directors are concerned, the standards are the same for government-elected directors and other directors.

The Korea Deposit Insurance Corporation (KDIC) investigates the actions of directors of insolvent banks and frequently files damages claims with the court against former directors (and controlling shareholders) of an insolvent financial institution who may be

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221 CHUL-SONG LEE, CORPORATE LAW 584-86 (12th edition 2005) (in Korean).

222 *See* Korea First Bank, Case No. 2000-Da-9086 (2002) (S. Korea).

responsible for the failure of the institution.[223] The procedure for a suit by the KDIC is available for both state-owned and privately owned banks, but in practice, most of the failures of financial institutions involved government-owned banks, which went bankrupt at the time of the East Asian financial crisis. As of the end of 2002, the KDIC had sued 4661 former directors and other employees of insolvent financial institutions for a total of 1296 billion Korean won (approximately U.S. $1.3 billion). There is no publicly-available data on the outcome of the litigations and actual recoveries. Still these lawsuits make it clear that government-appointed directors face the same risk of liability as other directors -- and perhaps more due to public outrage if their company fails.

United Kingdom

There is no provision in English law requiring a company to have "independent" or "outside" directors. (These terms are treated as synonymous.) However, the Combined Code on Corporate Governance §A.3.2 (2003 and 2006 editions) recommends that a listed company that is within the FTSE 350 have at least half its board comprised of independent directors. The Code is not law, however: A company listed on the London Stock Exchange must only explain to the market whether and how far it has complied with the Code.[224]

In the U.K., all directors are held to the same legal standards, unless an Act of Parliament or specific regulation draws a distinction between them, which very rarely happens.[225]

Of course, the standards applied to all directors, such as "reasonable care and skill" will vary in their practical application, because a full-time executive director can reasonably be expected to do more (and better) than a non-executive (*i.e.*, outside), who usually spends only a small part of his time on the company's business. As the courts have put it, "There is a considerable measure of agreement about the duty owed in law by a non-executive director to a company. In expression it does not differ from the duty owed by an executive director but in application it may and usually will do so."[226]

In an Australian case (which would be regarded as persuasive evidence of English law), a judge has raised the possibility that the non-executive chairman of a company should face stricter duties than other directors. However, the judge still approached the issue primarily by regarding the chairman as having greater responsibilities *as a matter of fact*, rather than due to a different legal standard.[227]

To summarize, the distinction between executive and non-executive (outside) directors in England involves their functions, not the legal standards they are to meet in performing

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223 Korean Depositor Protection Act, article 21-2.

224 LONDON STOCK EXCHANGE LISTING RULES §§ 9.8.6, 9.8.7, 9.8.10.

225 *See* Daniels v. Anderson, [1995] 16 A.C.S.R. 607 (Austl.) (approved and adopted in England in *Re* Barings plc (No. 5), [1999] 1 B.C.L.C. 433, 486-489 (H.C.), *upheld*, [2000] 1 B.C.L.C. 523, 534-535 (C.A.).

226 Equitable Life v. Bowley, [2003] EWHC 2263 (Comm), [2004] 1 B.C.L.C. 180, ¶ 35 (per Langley, J.).

227 *See* ASIC v. Rich [2003] NSWSC 85, [2004] 44 A.C.S.R. 341, ¶ 61 (per Austin, J.).

those functions. Applying the same standards to different functions can, naturally, result in different results.

Government-appointed directors

There are no differences in the standards of liability applicable to government-appointed directors, versus other directors. Directors, whoever appoints or elects them, are liable to the company in the same way.[228] Moreover, the government owes no duties to the company simply by virtue of making the appointment. The same is true for a major shareholder who is able to arrange for a representative to be elected to the board.[229]

A director appointed by a specific shareholder or interest group *may* take the interests of that group into account *but only so far as consistent with the best interests of the company.* If there is a conflict between the interests of the shareholder or entity whom the director represents and the interests of the company, the director will be well advised to abstain from voting. If the director participates in a decision which raises such a conflict, the rule is clear that the director breaches his duty by voting to favor the interests of the shareholder or entity whom he represents over the interests of the company.[230]

If the shareholder or other interest that a director represents attempts to coerce the director into voting to favor its own interests over those of the company, it can potentially be liable as well. However, such an attempt is very much a matter of specific fact that must be proven and will often, in practice, be difficult to prove.

As a factual matter, government-appointed directors are rare in the U.K., following the privatizations and Thatcher reforms of the 1980's.

United States

Inside versus outside directors

There is no difference in theory between the fiduciary duties of inside and outside directors -- both are equally subject to the duty of care.

When it comes to liability for breach of the duty of care, in contrast, in one sense, there is a large difference between the liability of inside and outside directors. This is due to the permission provided to companies in corporate statutes to adopt a charter provision that limits or eliminates the monetary liability of outside directors for breach of the duty of care, so long as the directors have acted in good faith. Assuming a company adopts a corresponding charter provision eliminating this liability -- and almost all public companies have done so -- inside directors are potentially liable for breach of the duty of care, while outside directors are not.

In another sense, there is no real difference in the potential liability of inside and outside directors -- both are almost never liable for breach of the duty of care. The reason lies in

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228 *See* Bennetts v. Bd. of Fire Commrs of NSW, [1967] 87 W.N. (NSW) 307; Charterbridge Corp. Ltd. v. Lloyds Bank Ltd., [1970] Ch. 62, 74-75.

229 *See* Kuwait Asia Bank EC v. Natl Mut. Life Nominees, Ltd., [1991] 1 A.C. 187.

230 Charterbridge Corp. Ltd. v. Lloyds Bank Ltd., [1970] Ch. 62, 74-75.

the separate defense provided by the business judgment rule, which provides that if a director acts on an informed basis and in good faith, the courts will not inquire into the merits of the decision that was taken.

The reported cases include a small number of decisions to the effect that the outside directors did not satisfy their duty to become reasonably informed, and thus did not benefit from the business judgment rule, which in turn allows scrutiny of their decision, and allows the court to find liability if the directors reached a decision in a grossly negligent manner. It is conceivable in theory, but far less likely in practice, due to the different nature of an inside director's job, that the inside director will be so ill informed that he will not satisfy the prerequisites for application of the business judgment rule. The same will hold true for corporate officers, who are subject to the same fiduciary duties as directors.

The net result is that, absent a conflict of interest, neither inside nor outside directors will be found liable for breach of fiduciary duty. This logic also applies to the potential for differences between directors who serve on particular committees, and to differences between ordinary directors and the chairman of the board. Whatever arguments one might construct in theory for why different standards might make sense are meaningless, in the face of an overall regime in which, as a practical matter, no director is ever found to face monetary damages for violating the duty of care.

For transactions involving a conflict of interest, there is no difference in the legal standards applied to inside and outside directors, and it is difficult to imagine a strong policy reason for such a difference to exist.

Directors of banks

Directors of banks face special risks for two reasons. First, they are subject to a duty of care that derives from banking law. While this duty is similar to the duty of care under corporate law, there is no ability of the bank to limit or eliminate the monetary liability of outside directors.

Second, the government insures bank deposits, and the deposit insurance agency has been willing to bring lawsuits against the former directors of insolvent banks, seeking recovery of damages, in situations in which a private shareholder would likely conclude that the potential recovery does not justify the expense of litigation. Such lawsuits have been brought against both inside and outside directors of failed banks.

Government directors

The political climate in the United States is strongly hostile to government ownership of business enterprises. When government ownership exists, it is (almost) invariably 100% ownership, and then the question of liability of government-appointed directors to the corporation or to outside shareholders does not arise.

There are a very small number of government-sponsored enterprises, but they operate under a specialized statute, and so their experience is not relevant to the rules governing ordinary business corporations.

For ordinary business corporations, one would have to search very hard to find an instance where a government representative is elected as a director, and there might be no such instances to be found at all. There is no case law discussing the liability of such a hypothetical government-elected director.

Summary and recommendations

We do not recommend establishing different standards of liability for different directors, depending on their positions, or on whether they serve on particular committees of the board of directors. The very complexity of the task, if one were to begin to draw distinctions between different types of directors, counsels against beginning the effort. The dominant approach in other countries is also not to draw distinctions between different types of directors, or between directors and senior managers.

For the most part, in our judgment, the same duties, and the same standards of liability should apply to all directors, with the following nuances, and with some need for special treatment of government-appointed directors.

Duty of care/reasonableness

Other countries do not draw a formal distinction between the degree of care or reasonableness expected of an executive versus a non-executive director. As a practical matter, however, executives are likely to face more severe scrutiny as to whether they devoted adequate attention to an important business issue than non-executives, simply because of the differences in their roles. The same will be true, to some extent, for decisions that are adopted or recommended by a committee of the board of directors, even if the committee's recommendation is approved by the entire board. Thus, as a practical matter, members of the audit committee will be expected to be more fully informed as to issues involving a company's financial statements, members of the compensation committee will be held to a higher standard for decisions involving executive compensation, a non-executive chairman may be held to a higher standard in general than other outside directors, a brand-new director will not be expected to know as much about the company's business as a long-serving director, and so on. We believe that distinctions of this sort do not need to be stated in the law, and can be left to the courts to determine, based on the facts of a particular case.

However, the experience of a number of other countries also suggests that if litigation against outside directors is a significant risk, then outside directors will be reluctant to serve. The ratio of reward (the modest compensation that is customarily paid) to risk (the potential for being found liable for very large damages) will simply be unacceptable.

Russia does not face this situation at the present time. Thus, we make no recommendations. Still, it may be worthwhile to discuss possible approaches, which may be worth considering in the future. There are several possible ways to address directors' concern about liability for decisions adopted in good faith. One is through a different standard of liability for outside directors, when the issue is only one of reasonableness and not good faith. For example outside directors who adopt a decision in a situation that does not involve a conflict of interest, either for the directors or for other directors, senior managers, or the controlling shareholder, could benefit from a presumption of reasonableness (see subchapter 1.3 for a recommendation on this issue), and could also be protected against liability unless the plaintiff shows that they acted with gross negligence, rather than simple negligence.

A second possibility is to limit the amount of monetary liability that outside directors face if they adopt decisions in a situation not involving a conflict of interest. For example, the United States allows companies to adopt charter provisions which eliminate *all* monetary liability of outside directors for breach of the duty of care. Japan allows a company to limit the liability of outside directors to twice their annual compensation. As a practical matter, this is low enough so that no one will sue them.

The concerns underlying the limits on the liability of outside directors are that if outside directors face potentially very large liability for their actions, they may be reluctant to serve or may be reluctant to take business risks that could lead to future liability, and that if outside directors are paid enough to overcome a reluctance to serve, the pay itself could be sufficient to compromise their independence.[231]

Duty of loyalty/good faith

This duty is applied to different persons in the comparison countries. For a controlling shareholder, the duty of good faith, in countries where it exists, is limited to transactions for which the controlling shareholder has a conflict of interest. But once the duty applies, it is the same for all persons subject to it in all of the comparison countries. We recommend that there should be a uniform duty of good faith, which should apply to directors, senior managers, and controlling shareholders.

Duty of disclosure

We recommend that the duty of disclosure should be phrased uniformly for all persons to whom it applies. As a practical matter, the duty of disclosure, like the duty of care or reasonableness, will be stricter for persons whose positions provide them with greater information about the company, and with a more central role in approving the company's disclosures.

Government-appointed directors

The duty of reasonableness contains two parts -- a duty to become informed, and a duty to act reasonably once informed, though with a presumption that a director who is informed and acts without a conflict of interest has also acted reasonably. See Subchapter 1.3. A government-appointed director should face the same obligation to become adequately informed. The government-appointed director should face the same duty of good faith, which can be violated by acting with a conflict of interest. The government-appointed director should face the same duty of disclosure.

However, there are two respects in which a government-appointed director, who under Russian law is required to vote in accordance with the written instructions of his superiors, should be excused from full compliance with the duties faced by other directors. The first is that a director who acts in accordance with written instructions from his superiors within the government should not be liable for a foolish decision, even

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231 *See* Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability: A Policy Analysis*, 162 JOURNAL OF INSTITUTIONAL AND THEORETICAL ECONOMICS 5 (2006), *at* http://ssrn.com/abstract=878135.

if the decision is unreasonable. Perhaps the government should be liable instead, though that is a topic beyond the scope of this Report. The liability of a government-appointed director who does not comply with the instructions of his superiors is not a question of company law and is similarly beyond the scope of this Report.

Second, we recommend that a government-appointed director who acts in accordance with written instructions from his superiors within the government should not be liable for a decision that is contrary to the interests of the company.

A government-appointed director should benefit from these exemptions only for matters on which he acts in accordance with written instructions, and should be required to prove that he did not solicit the instructions from his superiors in order to insulate a decision that was, in fact, his to make or to recommend to his superiors. That is, the protection should be limited to cases where the director was required by the nature of his position to act unreasonably or against the company's interests, not where he chose to do so.

Chapter 4. Application of labor law to members of company management organs

Issue: Which law should govern the relationship between a company and the members of the company's management organs: the JSC Law or the Labor Code? Which law should govern the relationship between the company and members of the board of directors: the JSC Law or the Labor Code?

General comment

In most of the comparison countries, including Canada, France (if a company has a one-tier board of directors), Korea, the United Kingdom, and the United States, companies have a unitary board of directors, which is the company's only "management organ." In these countries, we will interpret the first question to apply to the relationship between a company and its senior managers, who are often called officers. Some officers, especially the CEO, will often be members of the board of directors as well.

In countries with a two-tier board of directors, we will interpret the second question to refer to members of the supervisory board. In countries with a one-tier board of directors, we will interpret the second question to refer to outside directors, who are not officers of the company and customarily are not employed by the company on a full-time basis.

Russian context

At present, a unified opinion on the extent to which the Labor Code applies to the relationship between a company and the members of management organs has not developed. We will consider two questions:

- The application of the Labor Code to a single-person executive organ (or a member of the collegial executive organ).
- The application of the Labor Code to a member of the board of directors.

Application of the Labor Code to a single-person executive organ (a member of the collegial executive organ)

Norms regulating the relationship of a single-person executive organ (a member of the collegial executive organ) and a company are contained in the Labor Code, the Civil Code, and the JSC Law. These norms are not consistent, which leads to conflicts that can only be resolved by legislative amendments.

At present, the prevailing view is that the relationship between a single-person executive organ (a member of the collegial executive organ) and a company is subject to regulation under the Labor Code if a labor contract was concluded between them in accordance with Labor Code art. 16.[232] However, Labor Code arts. 11, 280 allow specific elements of the relationship between a single-person executive organ (a member of the collegial executive organ) to be established by other federal laws. At the same time, JSC Law art. 69(3) directly states that the provisions of labor law do not apply to the relationship between a company and a single-person executive organ (a member of the collegial executive organ) if there is a conflict between the JSC law and labor law. The provisions of the JSC Law thus might appear take priority with respect to labor law norms.

However, Labor Code art. 5 stipulates that labor legislation, defined as other federal laws containing labor law norms, should not contradict the Labor Code. This suggests that if there is a conflict between the labor law norms contained in the JSC Law and the norms of the Labor Code, the Labor Code applies. The JSC Law would then only govern specific aspects of the relationship between a company and a single-person executive organ (a member of the collegial executive organ).

A general principle of interpretation of Russian legislation provides that when two sources of legislation are at the same level, as is the case for the Labor Code and the JSC Law, the more specific law should control. This principle does not resolve the conflict, because one can see the JSC Law as more specific legislation with regard to the particular case of a single-person executive organ (a member of the collegial executive organ), but one can also see the Labor Code as more specific legislation with regard to the conditions of employment. Indeed, Labor Code art. 43 contains specific provisions concerning the employment of a single-person executive organ. Under Labor Code art. 280, these rules also apply to members of a company's collegial executive organ who have concluded a labor contract with the company. In legal practice, decisions can be found in which the court points to the fact that a single-person executive organ of a company shall bear liability on the basis of both Labor Code art. 277 and JSC Law art. 71, despite the differences between these provisions. In practice, the question of which source of norms takes precedence remains unresolved.

To make matters more complicated, the Labor Code is not internally consistent. Labor Code art. 277(1) establishes that the managers of an organization are liability *for direct*

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232 See, for example, P. V. Stepanov, *The Legal Qualification of the Relationship Arising between a Single-Person Executive Organ and a Joint-Stock Company,* ECONOMICS AND LAW, No. 12 (2002), at 95-97 (П.В. Степанов *Правовая квалификация отношений, возникающих между единоличным исполнительным органом и акционерным обществом,* ХОЗЯЙСТВО И ПРАВО); L. Chikanova, *Consultation: Answering Readers' Questions,* ECONOMICS AND LAW, No 2 (2003) (Л. Чиканова *Консультация: отвечаем на вопросы читателей,* ХОЗЯЙСТВО И ПРАВО).

real damages caused to the organization. This measure of damages includes losses suffered by the company, but excludes liability for lost profits. Yet Labor Code art. 277(2) provides that these persons shall compensate the organization for *losses* in cases provided for by law. The calculation of losses is to be carried out in accordance with Civil Code art. 15, and thus includes lost profit. The measure of damages under JSC Law art. 71 is losses, and hence also includes lost profit.[233]

Application of the Labor Code to a member of the board of directors

The Labor Code, the Civil Code, and the JSC Law also each include norms regulating the relationship between a member of the board of directors and a company. Here too, there is no consensus on which norms should be used when civil law and labor law conflict.

Under Labor Code art. 11, the provisions of the Labor Code generally do not apply to members of the board of directors of organizations. An exception exists for cases where a member of the board of directors has concluded a labor contract with the company. A decree of the Plenum of the Supreme Court confirms the possibility of concluding a labor contract with a member of the board of directors.[234] In contrast, the arbitrazh courts hold the opinion that the relationship between a member of the board of directors and a company is regulated solely by civil legislation.[235]

At least for non-executive directors, a company can ensure that the relationship between the company and its directors is governed by civil law by not entering into a labor contract with the directors. The JSC Law does not require that the company conclude any type of contract with members of the board of directors.

A separate question from whether the Labor Code applies to directors is to which activities does it potentially apply? Most of the activities of members of the board of directors would not be considered to be "labor activities" under Labor Code art. 15. For example, it is difficult to say that directors they are subject to a company's internal labor procedure or are required to fulfill the instructions of other officers of the company; the character of the function they are fulfilling does not presuppose daily involvement in the company's activities, and so on. The board of directors is responsible for the formation of the executive organ of the company and early termination of its powers (JSC Law art. 65), and exercises other controlling functions with respect to it (e.g., approving major transactions and self-interested transactions). Thus, the board of directors occupies a higher position than the single-person or collegial executive organ. This higher status is explicitly seen in JSC Law art. 69, under which "the company's executive organ shall organize the fulfillment of decisions of the board of directors". Thus, it would clearly be

233 We discuss the concept of losses in Russian law in Chapter 9.

234 Decision of the Plenum of the Supreme Court of the Russian Federation No. 17, On Some Problems Arising in Legal Practice during the Examination of Cases on Labor Disputes with Joint-Stock Companies, Other Economic Partnerships, and Companies (Nov. 20, 2003) (Постановление Пленума Верховного Суда Российской Федерации от 20 ноября 2003 г. № 17 «О некоторых вопросах, возникших в судебной практике при рассмотрении дел по трудовым спорам с участием акционерных обществ, иных хозяйственных товариществ и обществ»).

235 See, for example, Decision of the Federal Arbitrazh Court of the Eastern-Siberian District No. A33-13211/05-F02-61/06-S1 (Feb. 2, 2006), (Постановление Федерального Арбитражного суда Восточно-Сибирского Округа от 02.02.2006 N А33-13211/05-Ф02-61/06-С1).

impractical to consider the activities of members of the board of directors to be labor activities, which would imply that the directors were subordinate to the single-person executive organ and could potentially be fined by the single-person executive organ (acting in the name of the company) for improper fulfillment of their duties.

Moreover, under Labor Code art. 136, the "condition of payment of labor" is the essential condition of a labor contract, wages "are paid out no less frequently than every half-month," and their amount cannot be less than the minimal payment of labor at that current time (Labor Code art. 133). Under JSC Law art. 64, though, the company cannot pay for work performed by a member of the board of directors unless compensation is approved by a general shareholder meeting.

In our view, therefore, severe problems would be created if the relationship between a company and members of the board of directors were to be fully governed by labor legislation. Fortunately, companies can readily avoid these problems, at least for non-executive directors, by not entering into labor contracts with these persons. The situation is more complex for an executive director, who is more likely to be also carrying out the functions of an employee of the company.

Canada

Officers

In Canada, the person who serves as chief executive officer will almost invariably also be a director. Other senior executives may serve on the board of directors as well. Under Canadian law, when determining the law governing appointment and dismissal of senior managers, one must distinguish between (i) managers who are both officers and members of the board of directors and (ii) other senior managers, who are officers of the company but are not members of the board of directors. Managers who are also members of the board of directors hold, in effect, two positions – a position as an officer of the company, and a position as a member of the board of directors. These two positions must be considered separately.

Canadian corporate legislation gives the shareholders the right to elect or appoint directors at annual shareholder meetings (CBCA § 106, OBCA § 119). Shareholders also have the right to dismiss a director at any time, for any reason, before his/her term expires (CBCA § 109, OBCA, § 122). Employment legislation does not govern the election or dismissal of directors. Thus, directors are not entitled to advance notice of termination, in contrast to typical full-time employees, who must receive reasonable notice under labor legislation.[236] The power of the shareholders to remove directors is general and does not require the director to have misbehaved. The same rules apply to both inside directors (directors who are also officers) and outside directors (directors who are not also officers).

While the shareholders have the exclusive power to elect and dismiss directors, a corporation's board of directors may appoint and dismiss the officers of the corporation (e.g. CBCA § 121, OBCA § 133). Standard practice, especially for a public company, is

236 KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 866 (1999).

for its officers to enter into a managerial services contract with the corporation. The contract may specify certain grounds on which the officer may be dismissed for cause. If an officer is not dismissed for cause, the corporation will have breached the managerial services contract and the officer will be entitled to damages. The cause of action is generally known as "wrongful dismissal." In any event, if the board of directors dismisses an officer, the officer loses his official powers and duties, and is generally left only with his rights to compensation under the contract.

The Canadian courts, as a general matter, will not grant specific performance of an employment contract or order reinstatement of an employee in a wrongful dismissal action. Thus, an officer will not have any right to keep his job, but will instead have an action for damages.[237]

If an officer or director is also a shareholder, there is an additional remedy available. Removal from one's position as an officer or as a director, can potentially constitute "oppression" or "unfair prejudice."[238] A judge who makes a finding of oppression could theoretically order reinstatement of an officer after dismissal, since judges have broad discretion to order whatever remedies they consider appropriate. However, a judge is only likely to find that being dismissed from a managerial position constitutes oppression if the purpose of the dismissal was to permit a dominant shareholder to acquire the applicant's shares for less than their fair value, or if the applicant had a "reasonable expectation" of continued employment based on an explicit or implicit understanding to that effect.[239] Also, judges in oppression remedy cases usually do not seek to impose extreme remedies, favoring instead the least meddlesome approach that will do justice in the particular case.[240] Thus, a court would be much more likely to order a buy-out of the applicant's shares at fair value than to give him his job back. The buy-out remedy is expressly endorsed in the corporate statutes (CBCA § 241, OBCA § 248).

Outside directors

Outside directors are not considered to be employees of the company. Accordingly, the relationship of outside directors with the company is governed by corporate law and not by employment law.

A director who has been dismissed by a controlling shareholder would, in theory, be able to bring a suit for oppression or unfair prejudice, similar to the suit that might be brought by an officer.[241] However, a finding of oppression is unlikely if there were genuine attempts at a compromise before the dismissal and the complainant's rights as a shareholder are being respected.[242] More generally, oppression claims are unlikely to succeed for public companies.

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237 KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 800 (1999).

238 *Diligenti v. RWMD Operations Kelowna* (1977) 4 British Columbia Law Reports 134).

239 MARKUS KOEHNEN, OPPRESSION AND RELATED REMEDIES 152-160 (2004).

240 KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 800, 985 (1999).

241 See, for example, *Diligenti v. RWMD Operations Kelowna* (1977) 4 B.C.L.R. 134.

242 KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 794 (1999).

France

One-tier board

Members of the one-tier board in general

French corporate law strictly distinguishes between the position of director, CEO, assistant general manager, and employee. With respect to tax and social security law, directors, CEOs, and assistant general managers are treated as employees.[243] With respect to labor law and company law, a director is generally not treated as an employees, although with the possibility for a limited exception, as discussed next.

With regard to directors, in some companies, some directors are elected by the employees.[244] In these cases of employee co-determination i the elected directors are permitted to keep their positions as employees. They would thus be subject to the protections against dismissal provided by labor law.

For directors who are elected by the shareholders, the starting point is Code de Commerce art. L. 225-22, which states that

> an employee of the company may not be appointed as a director unless their employment contract corresponds to a real employment. They shall not lose the benefit of this employment contract. Any appointment [as a director] made in breach of the provisions of this subparagraph shall be null and void. This nullity shall not cause that of the deliberations in which the irregularly appointed director has participated. The number of directors bound to the company by an employment contract may not exceed one third of the directors in office . . . .

French courts have deduced from this provision that existing employees can later also become directors, subject to the one-third limit on employee-directors, but existing directors cannot become employees. An employment contract between a company and a person who was initially elected as a director is regarded as null.[245]

If the requirements of Code de Commerce art. L. 225-22 are met, the person's positions as director and employee are considered to be independent. Remuneration as a director is not based on the employment contract. Directors can always be dismissed (Code de Commerce art. L. 225-18(2), 225-105(3)), but this will not affect a person's status as an employee. These rules also apply to CEOs and assistant general managers who are members of the board of directors. They can be employees only if they were first employees, with a "real employment." If so, their position as employee is separate from both their position as director and their position as CEO or assistant general manager.

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243 Cf. Francis Lefebvre, *Mémento Sociétés commerciales* (2006), ¶¶ 8715, 9203.

244 Cf. Code de Commerce arts. L. 225-28, 31, 32.

245 Cass. com 7 mars 1989, Bull. IV no. 80; Cass. soc. 22 avril 1992, Bull. V no. 293; Cass. soc. 2 novembre 1993, RJDA 2/94 no 178; Cass. soc. 25 juin 1996, RJDA 11/96 no 1349.

CEO and Assistant General Manager

A CEO or assistant general manager who is not a member of the board may enter into a separate employment contracts with the company.[246] Here too, the two positions are seen as independent. A CEO or assistant manager can be dismissed by the board at any time with or without cause (Code de Commerce art. L. 225-55). If this person is dismissed without cause, the dismissal may give rise to a claim for compensation. Furthermore, the separate employment contract may continue to exist.

Two-tier board

Management board

For a firm with a two-tier board, the dismissal of members of the management board is addressed in Code de Commerce art. L. 225-61, which states that

> the members of the management or the sole managing director may be dismissed by the general meeting, and also, if the memorandum and articles of association so provide, by the supervisory board. If the decision to dismiss them is unreasonable, they may be entitled to sue for damages. If the interested party has entered into a contract of employment with the company, their dismissal from the post of director shall not have the effect of terminating the said contract.

It follows from this that employment contracts between a company and the members of the management board are possible but the employment contract and the person's authority under company law are treated as separate. If the shareholder meeting or the supervisory board dismisses a member of the management board from his position on the management board, he loses his powers, but may retain a claim for damages and, unless the dismissal is for cause, will retain his position as an employee.

Supervisory board

The rules governing members of the supervisory board, for a firm with a two-tier board, are similar to the rules discussed above for the board of directors of a firm with a one-tier board. An employee can become a supervisory director, but a person who begins as a supervisory director cannot become an employee. A separate employment contract is possible for board members who are elected by the employees.

For board members who are elected by the shareholders, Code de Commerce art. L. 225-85 states:

> Members of the supervisory board shall not receive any remuneration, whether permanent or otherwise, from the company, other than that provided in Articles L.225-81, L.225-83 and L.3225-84, and, if appropriate, those payable under a contract of employment for a post actually held. The number of members of the supervisory board bound to the company by a contract of employment must not exceed a third of the members in office at any given time.

246 FRANCIS LEFEBVRE, MEMENTO SOCIETES COMMERCIALES ¶ 8806 (2006).

If a supervisory director has a valid employment contract, that contract is treated as separate from his position as a member of the board. Thus, labor law does not affect the power of the shareholders to dismiss a supervisory director.

Germany and Austria

Management board members

The members of the management board are appointed by the supervisory board for a period of at most five years (AktG § 84 I). The appointment can only be revoked for cause, such as severe breaches of duty, incapability to manage the company, or a vote of no confidence by shareholders (unless the vote was obviously not based on objective grounds) (AktG §84 III).

German law distinguishes between the powers of a member of the management board to manage the company under corporate law and the contractual relationship between the managing director and the company. AktG § 84 I 5 provides that the rules governing the appointment of a member of the management board, for purposes of his powers under corporate law, also apply to the employment contract between the company and the manager. The employment contract may stipulate that it remains in force if the manager is reappointed to a new term after his prior term in office has expired.

However, the work contract is generally considered to be a contract for personal services and not a contract for employment. Thus, it is not governed by labor law. The theory is that the members of the management board, because of their authority to manage the company, are not "employees", who are conceived of as persons who take instructions from other persons at a more senior level in a company's hierarchy of management.[247] Austria follows a similar approach.[248]

Although the board member's service contract with the firm is considered separately from his corporate function, his removal from his corporate function will also result in the termination of the contract. However, as the service contract is governed by the German Civil Code, the criteria of Civil Code § 626 must be met if dismissal is to have immediate effect.[249] This provision requires a comprehensive consideration and balancing of the interests of both parties as to whether an immediate dismissal can be considered equitable under the specific circumstances.

If the supervisory board revoked an appointment to the management board because of a "severe breach of duty", this cause will typically suffice to justify an immediate termination of the contract for personal services. However, if the supervisory board revokes the appointment following a vote of no confidence at a shareholder meeting,

247 BGHZ 12, 1, 8; BGHZ 36, 142, BGHZ 49, 30; BGHZ 79, 38, 41, BGH WM 1988, 298, 299; Wolfgang Hefermehl and Gerald Spindler, in 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 84, ¶ 43 (Bruno Kropff and Johannes Semler editors, 2nd edition, 2004); UWE HÜFFER, AKTIENGESETZ § 84, ¶ 11 (7th edition, 2006).

248 See Christian Nowotny, in KOMMENTAR ZUM AKTIENGESETZ § 75, ¶ 14 (Peter Doralt, Christian Nowotny and Susanne Kalss editors, 2003).

249 *For example,* BGH WM 1995, 2064, 2065.

whether a immediate termination of the contract is justified will depend on the specific reasons for this vote.[250] In the (unusual) case where a management board member's appointment may be revoked under corporate law, but he may not be dismissed under civil law, the notice periods laid down in German Civil Code § 621 must be satisfied before the termination of the service contract becomes effective. The usual notice period is two weeks (German Civil Code § 626 II). In the interim, the manager remains entitled to the compensation specified in the contract.

Supervisory board members

Members of the supervisory board (apart from employee representatives) are normally elected by the shareholders (AktG §101 I). There is, at least according to the prevailing opinion, no direct contractual relationship between the company and the supervisory board member, and no employment relationship.[251] Thus, labor law does not affect the tenure or compensation of supervisory directors. However, some employee representatives on the supervisory board are required be employees of the company (MitbestG § 7 II).

Members of the supervisory board who are elected by shareholders can be recalled by a supermajority vote of 75% at any time, unless the charter stipulates otherwise (AktG § 103 I). The charter may also give specific shareholders the right to designate up to 1/3 of the shareholder representatives (AktG § 101 II). In this case, the shareholder who appointed a board member may revoke his appointment (AktG § 103 II).

Korea

Directors in general

In Korea, directors are permitted to be, but are not required to be, employees of a company. In most cases, no specific directors' service contracts are made between the company and the director, but such contracts are permitted and sometimes used.

In Korea, directors' positions as directors are not affected by labor law, even in the case where a director is also an employee. The KCC provides that a director may be removed from office at any time by a two-thirds vote of shareholders present at a general shareholders' meeting. In the usual case in which the director serves for a fixed term, if he is removed without cause, he is generally entitled to continue to be paid for the remainder of his term (KCC art. 385 ¶ 1).

Executive directors

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250 UWE HÜFFER, AKTIENGESETZ § 84, ¶ 39 (7th edition, 2006).

251 *For example* Michael Hoffmann-Becking, *Rechte und Pflichten der Aufsichtsratsmitglieder,* in 4 MÜNCHENER HANDBUCH DES GESELLSCHAFTSRECHTS: AKTIENGESELLSCHAFT § 33, ¶ 10 (Michael Hoffmann-Becking editor, 2nd edition 1999); Johannes Semler, in 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 101, ¶ 156 (Bruno Kropff and Johannes Semler editors, 2nd edition, 2004); UWE HÜFFER, AKTIENGESETZ § 101, ¶ 2 (7th edition, 2006). There is some old case law suggesting that supervisory directors should be considered to be employees (RGZ 146, 145, 152; RGZ 152, 273, 278), but these decisions are apparently no longer considered to be good law.

Executive directors are governed by both the KCC and by labor law. Korean law requires the shareholders to approve the total compensation paid to all directors. This includes the compensation of executive directors.[252] According to the Korean Supreme Court (Case No. 2002-Da-64681), however, a director's remuneration should be protected by the labor law to the extent that as the substance of the director's work corresponds that of an employee of the company. Here, the most important factor will be whether the director works under the instruction and supervision of the CEO, similar to an ordinary employee. If so, his relationship with the company, and his rights if dismissed from his position, should be governed by labor law. This would presumably apply only to his position as an employee, while his separate position as a director would be governed by the rules for directors.

Officers who are not directors

The KCC contains no specific requirements for officers who are not directors. Thus, there exists a legal vacuum in their status and liabilities. It is possible for a non-director officer to be regarded as a *de facto* director, in which case he will have the same duties and potential liabilities as an actual director (KCC art. 401-2).[253] Otherwise, since the position of officer is not recognized under the KCC, the relationship between a senior manager and the company will be governed by labor law and contract law.

Until recently, it was common for senior managers to be members of the board of directors, so the issue of the status and fiduciary duties of senior managers who are not directors did not often arise. However, in the last few years, Korean public companies have reduced the number of executive directors to satisfy new requirements that outside directors must be at least one fourth of the total number of directors. Also, public companies with assets of at least 2 trillion Korean won (about US $2 billion) or more at the end of the immediately preceding business year must have at least three outside directors and outside directors must be at least half of the total number of directors (KSEA art. 191-16 ¶ 1) The (unfortunate) result is that many large Korean companies are now managed, in significant part, by officers who are not directors and thus are not subject to liability rules of the KCC.

Latvia

A specific provision in Art. 44(3) of the Latvian Labor Law addresses the status of members of the executive bodies of joint stock companies:

> An employment contract with members of executive bodies of [joint stock] companies shall be entered into, unless they are employed on the basis of another contract governed by civil law. If the executive body of a [joint stock] company is employed on the basis of an employment contract, [the contract] shall be entered into for a specified period."

252 CHUL-SONG LEE, CORPORATE LAW 527 (12th edition, 2005) (in Korean) at 527; KI WON CHOI, COMPANY LAW 586 (12th edition, 2005) (in Korean).

253 The concept of a *de facto* director is discussed in more detail in chapter 5.

However, we have been advised by a Latvian lawyer that courts do not apply this provision in a strict sense. Thus, if there is not a specific contract, either an employment contract or a contract for services, this does not necessarily lead to the conclusion that an employment relationship exists between the company and a member of an executive body.

Labor Law art. 44(3) does not affect the powers and duties of the members of the management board under joint stock company law. Thus, under Latvian Commercial Code § 306, members of the management board can always be recalled by the supervisory board if there is a basis for doing so under company law. Furthermore, we were advised that if a person's membership in the management board is terminated, the person's employment contract is considered to end.

United Kingdom

Executive directors

Directors are appointed in accordance with the company's charter. Under standard default charter terms, this means that they are elected by the shareholders.[254] Directors' relations with a company are governed fundamentally by corporate law rather than labor law. Executive directors can (and often do) also have employment contracts with the company. (Non-executive directors typically have a contract for services, rather than an employment contract.) However, executives' rights under these employment contracts are subordinate to company law in the following vitally important ways.

The employment contract cannot limit the fiduciary duties owed by officers and directors under company law (Companies Act 1985, §§ 309A-309C, replaced by Companies Act 2006, § 180). Also, directors can always be dismissed without cause by a majority vote of shareholders, notwithstanding any contract (Companies Act 1985 §. 303, replaced by Companies Act 2006, § 168). If this dismissal is a breach of a contract between the company and a director, the director may have a claim for compensation from the company under a "wrongful dismissal" claim, but has no right to retain his position. The damages payable for wrongful dismissal will depend on a range of factors, including the period of the contract left unexpired and the expectation that someone who is the victim of a breach of contract should seek to minimize his loss. (Other theoretical possible sources of corporate liability for dismissal, these being an "unfair dismissal" claim and a "redundancy" claim, are discussed below).

Senior managers who are not directors

Senior managers who are not directors will be appointed in accordance with the company's charter. This usually means that they will be appointed by the board of directors, or by someone to whom the board of directors has delegated this task. Such a manager will typically enter into an employment contract with the company. The relationship between such a manager and the company is primarily a matter of contract supplemented by fiduciary duties. These duties are not waivable by contract.

254 See, for example, the default charter terms in Table A regulations 73-80.

If a senior manager is dismissed, and the dismissal is a breach of contract, he will have a claim for damages for breach of contract, but no right to retain his position. While a court could, in theory, order such the reinstatement of a manager, this remedy would be extremely rare. Courts generally will not issue orders for specific performance of a contract which would require people to work together who have fallen out, based on the view that such orders are very difficult, expensive and inefficient to enforce.[255]

All senior managers

If a senior manager concerned is an "employee" within the relevant definition of the UK employment protection legislation (labor law), he may have a claim under statute for "unfair dismissal", which is essentially a claim triggered by a failure to follow due process in the dismissal. The manager might also have a claim under statute for a "redundancy payment" if his position is being eliminated due to changes in the company's financial and business conditions. However, the maximum amounts recoverable for unfair dismissal or as a redundancy payment are usually lower than a senior manager would be likely to recover for breach of contract (wrongful dismissal). Since a claimant cannot recover money compensation twice for the same loss, senior managers rarely pursue these claims.

Non-executive directors

Non-executive directors are not considered to be employees and are not protected by English labor law. The commonly enter into contracts for services with the company, which provide for compensation. Their continuation in office is determined by company law, as discussed above for executive directors. Their compensation, if they are dismissed before the end of the term, is a matter of ordinary contract law as applied to contracts for services.

Finally, if the person dismissed is also a shareholder, he may be able to allege that the dismissal amounts to "unfair prejudice" under Companies Act § 459. The argument would be that his dismissal infringed the basis on which he became a shareholder. This claim might be possible if he could show that when he became a shareholder, he had reason to expect (because of explicit or implicit undertakings or representations) that he would participate in management of the company. If this argument were successful, the available remedies include reinstatement. However, that would be unusual, because the courts rarely order people to work together who have fallen out. These considerations apply with particular force to listed companies, because of the potential for harm to outside shareholders.[256]

United States

Directors

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255 See JONES AND GOODHART ON SPECIFIC PERFORMANCE 169-176 (2nd edition, 1996).

256 For empirical confirmation of the assertion that reinstatement is a rare remedy, see Law Commission for England and Wales, *Shareholder Remedies*, Consultation Paper No. 142 (1996) at 94-95, 237, updated in Law Commission for England and Wales, *Shareholder Remedies*, Final Report No. 246 (1997), at 27-28, 179.

In the United States, company law controls the dismissal of directors and officers, as well as their obligations to the company. If all directors are elected annually, they may generally be dismissed for any reason by a decision of shareholders.[257] In practice, however, it is extremely rare for a shareholder meeting to be called for this purpose by a public company. It is simpler, in practice, either for the remaining directors to advise the director with whom they are unhappy to resign, or for them to ignore him if he is unwilling to resign.

If a company's charter provides that directors are elected for staggered terms (usually three year terms), a director can generally only be dismissed for cause.[258] But again, dismissal is governed by company law, not by labor law.

A director may have a compensation contract with the company. If so, the contract may provide for payment of compensation for the director's remaining term in the event of dismissal without cause. The director will have, however, only a right to compensation, and no right to continue in office.

In any event, directors who are not officers are not considered to be employees, and would not be protected by labor law, with respect to their positions. And if they were employees, labor law would provide little protection anyway. The general U.S. rule is that, while an employee may not be dismissed for an improper reason (age, gender, race, ethnic background), an employee may be dismissed for no reason at all, and receive on dismissal only whatever compensation is provided for under the company's customary severance policies or under an employment contract.

Officers

An officer may or may not also be a director. The two positions are treated separately. See the discussion above with regard to the director position. With regard to an officer position, this is considered employment, so labor law would apply, but will usually provide little protection, as noted above.

Under company law, officers are appointed by the board of directors, and may be removed by the board at any time, for any reason. The officer's employment contract will typically specify the compensation to be paid upon dismissal. It will not specify any rights to remain in office, because any such rights would not be enforceable in any event.

If an officer is removed for an improper reason, the officer would have a claim for damages under anti-discrimination law, but would not have a claim for reinstatement.. Anti-discrimination laws also vary in whether they cover senior company executives to begin with.

Summary and recommendations

The key to addressing the rights of managers and directors under labor law is to separate the right to continue in one's position from the right to compensation.

257 Delaware General Corporation Law § 141(k).

258 Delaware General Corporation Law § 141(k)(i).

Members of the company's executive organ

We recommend that the right of members of the company's management organs to continue in his position should be governed by company law. If the board of directors dismisses the CEO or a member of the collegial executive organ, whether for good reason, bad reason, or no reason, this person loses his powers. He may have a claim for damages under his employment contract. He may have a claim for compensation under labor law. He may even have a claim to continued employment in a lesser position under labor law.

In some countries, labor law provides some assured minimum level of compensation to a manager who has been dismissed. However, as a practical matter, even when this is the case, the manager's contractual rights usually provide larger payments than the minimum amounts provided under labor law. Thus, the practical importance of labor law is limited.

In some countries, labor law provides some assurance of continued employment to a manager who has been dismissed, though in a lesser position. However, as a practical matter, this is unlikely to be attractive to a senior manager. Thus, the practical importance of labor law is again limited.

We understand that the principle that the JSC Law governs the appointment and dismissal of members of the company's management organs to has been clarified in Russian through a combination of judicial decisions and recent amendments to the Labor Code. No further change is recommended.

Executives who are also members of the board of directors

When a member of the company's executive organ is also a member of the board of directors, we recommend that the two positions should be seen as independent of each other. A person can be dismissed as a member of the executive organ by the board of directors, yet remain a member of the board of directors until his term expires. As a practical matter, however, an executive who is dismissed from his management position will usually resign from the board of directors.

Directors

Directors are elected by shareholders, and can be dismissed only by shareholders. As a practical matter, given that directors serve only for one-year terms under Russian law, it will rarely be worth while to convene a shareholder meeting to dismiss a director before the end of his term. If this happens, a question can arise as to whether the director has any rights to compensation.

This question has not arisen in the comparison countries. To address the unusual case in which a director who is dismissed early by decision of a general shareholder meeting, we recommend that the dismissed director should receive the compensation which he would have been paid for the remainder of his term, with an exception if the dismissal is for good cause, such as a breach of duty to the company or neglect of one's duties.

Chapter 5. Liability of managing organization (individual manager) and employees of managing organization

Issue: What should the liability rules be for a managing organization which manages a joint stock company, or for a member of the management organs of such a managing organization, or for an individual manager?

Russian context

Civil Code art. 103 and JSC Law art. 69 establish the possibility of the transfer of powers of a company's executive organ to another commercial organization (managing organization) or a private entrepreneur (manager) (below, we refer to both together as a "manager"). If the indicated powers are transferred, the manager's relationship with the company is governed by a civil contract on management.

Under JSC Law art. 69(1), the decision to transfer the powers of the executive organ to a manger must be adopted by a general shareholder meeting based on a proposal by the board of directors. The selection of a manager and the specific terms of the contract can be carried out either by the general shareholder meeting or by the board of directors, if the charter gives this power to the board of directors.

The JSC Law does not regulate the terms of a contract with a professional manager; however, the Code of Corporate Governance, chapter 4, § 2.1.10, recommends the following conditions:

- the goals that the manager should seek to achieve;
- the amount of the manager's compensation;
- the manager's liability of the manager for failure to fulfill his obligations;
- the procedure for terminating the manager's powers;
- the scope and content of the information and reports which the manager must present to the board of directors and shareholders, etc.;

In the opinion of some scholars, the contract between a legal entity and a manager is a type of contract on compensated providing of services.[259] Other scholars believe that while the contract on management includes elements of a contract on compensated providing of services, it should be seen as a mixed contract, containing elements of various forms of contracts, in accordance with Civil Code art. 421.[260] In our opinion, from a practical point of view, it is desirable to specify in the contract on management

259 See, for example, S. D. MOGILEVSKIY, BODIES OF MANAGEMENT OF ECONOMIC ENTITIES (Delo Press, 2001) (С.Д МОГИЛЕВСКИЙ. ОРГАНЫ УПРАВЛЕНИЯ ХОЗЯЙСТВЕННЫМИ ОБЩЕСТВАМИ, Издательство «Дело»); P. V. Stepanov, *The Legal Qualification of the Relationship Arising between a Single-Person Executive Organ and a Joint-Stock Company,* ECONOMICS AND LAW, No 12 (2002) at 95-97 (П.В. Степанов *Правовая квалификация отношений, возникающих между единоличным исполнительным органом и акционерным обществом*, ХОЗЯЙСТВО И ПРАВО).

260 A. Dyagilev, *The Transfer of the Powers of a Single-Person Executive Organ to a Managing Organization*, ECONOMICS AND LAW, No 12 (2003) at 47 (А. Дягилев *Передача полномочий единоличного исполнительного органа управляющей организации,* ХОЗЯЙСТВО И ПРАВО).

that it is a mixed contract, not directly provided for by the existing Civil Code, but not proscribed by it.

Under JSC Law art 69(4), by decision of a company's general shareholder meeting, the powers of a manager can, at any time, be terminated early. The JSC Law, however, does not specify any special bases for such an early termination of powers. It is not clear whether this power is unlimited, or whether the grounds for early termination can be specified in the contract with the manager.

Suppose that the powers of the executive organ are transferred to a managing organization, which it itself a legal entity. In general, the general director of the managing organization can, without a power of attorney, sign documents and act in the name of the manager. It is unclear whether this person can also act without a power of attorney on behalf of the company. In practice, this uncertainty can create problems when concluding transactions. A common solution in practice is to provide the general director of the managing organization with an explicit power of attorney to act on the company's behalf.[261]

The liability rules of JSC Law art. 71 apply equally to a managing organization or an individual manager as the executive organ of a company. Under Civil Code art. 401(3), unless otherwise provided by law, during the conduct of entrepreneurial activities (which would clearly include the actions of a managing organization or individual manager in representing a joint-stock company), an entrepreneur is liable without regard to fault if he does not prove that the fulfillment of duties was impossible as a result of extraordinary and unavoidable circumstances. Since JSC Law art. 71 limits the liability of the managing organization or manager to actions which are not reasonable, not in good faith, or not in the interests of the company, it provides narrower liability for these persons than under this general Civil Code provision.

The usual rules for when a shareholder can bring a suit for damages against a member of a company's management organs also apply to suits against a manager. Such a suit can be brought by the managed company or by shareholders, possessing in the aggregate at least 1% of the company's common shares of a company (JSC Law art. 71).

Under existing legislation, the shareholders of a controlled company cannot directly sue the general director of a managing organization. These persons can be held liable only through the following two steps (for simplicity, we will assume that the managing organization is a company rather than another form of legal entity)

1. First, the controlled company or its shareholders can bring a suit against the managing organization under JSC Law art. 71.

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261 See N. V. KOZLOVA, THE LEGAL PERSONALITY OF A LEGAL ENTITY (Statut Press, 2005) (Н.В. КОЗЛОВА, ПРАВОСУБЪЕКТНОСТЬ ЮРИДИЧЕСКОГО ЛИЦА, Статут). If, the managing organization delegates its duties to its own single-person executive organ, another employee of the managing organization, or another person, a relationship of typical representation arises between a concrete physical person and the controlled company, and the general director of the managing company should give this person a power of attorney to act in the name of the controlled company.

2. Second, the managing organization or its shareholders can bring a suit against the general director for the actions which resulted in liability on the part of the managing organization.

The bases for holding employees of a managing organization other than its general director liable is more complex. As mentioned above, such a person carries out management duties on the basis of a power of attorney given by the general director of the managing organization. The relationship of representation between such an employee and the controlled company is based on a combination of contracts: (a) the contract for management between the managing organization and the controlled company and (b) a labor contract between the managing organization and its employee who carries out management activities. Holding a concrete employee of a managing company liable for losses caused to the controlled company is thus, once again, possible only in two stages. Moreover, the employee is liable only for actual losses suffered by the managing organization, not losses suffered by the controlled company, and not lost profits.

From a practical point of view, then, it is extremely difficult to hold liable either the general director or an employee of the managing organization. The principal recourse of the controlled company and its shareholders are against the managing organization. If the managing organization has limited assets, then there is likely to be no effective recourse.

A second possibility exists to hold a managing organization liable. Some scholars believe that because the managing organization has the opportunity to determine the decisions of the controlled company, the controlled company is a subsidiary company of the managing organization under Civil Code art. 105(1). The managing organization could then be found liable using the norms of joint and secondary liability, provided by Civil Code art. 105.[262] Other scholars disagree with this point of view.[263] This question has not yet been addressed by the courts.

Canada

Under Canadian law, a managing organization cannot manage a corporation directly because the company is managed by the board of directors. The board cannot delegate its authority to manage the company to a person who is not a director, and a company cannot serve as a director.

There is no common law requirement that a director must be a natural person.[264] Canadian corporate legislation typically stipulates, however, that a person who is not an individual cannot serve as a director (CBCA § 105, OBCA § 118). There is a similar

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262 See, for example, 1 CIVIL LAW (Y. A. Sukhanov editor, 2002) (ГРАЖДАНСКОЕ ПРАВО, ПОД РЕД. Е.А. СУХАНОВА); A. Molotnikov, *Russian Holding Companies: Features of Functioning*, COLLEGIUM, No 7 (2004) at 54 (А. Молотников *Российские холдинговые компании: Особенности функционирования,* КОЛЛЕГИЯ).

263 See I. S. SHITKINA, HOLDINGS: LEGAL REGULATION AND CORPORATE MANAGEMENT: A SCIENTIFIC-PRACTICAL EDITION (Lawyer Press, 2001) (И.С. ШИТКИНА ХОЛДИНГИ: ПРАВОВОЕ РЕГУЛИРОВАНИЕ И КОРПОРАТИВНОЕ УПРАВЛЕНИЕ: НАУЧНО-ПРАКТИЧЕСКОЕ ИЗДАНИЕ, Юрист).

264 KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 648 (1999).

requirement that officers be natural persons (CBCA § 1, OBCA § 1, defining "individual" and " officer").

With regard to delegation of authority by the board of directors, CBCA § 115(1) and OBCA § 127 permit delegation of the board's powers only to a "managing director" who must be a resident Canadian, or to a committee of directors. Since the managing director and any directors on a committee must be natural persons, board functions cannot be delegated to a management company.

If a managing organization appointed individuals to serve as directors of a corporation it was charged with managing, those directors would owe the corporation the same duties as other directors. As is the case with government-appointed directors, the fact that a managing organization had appointed the directors would offer the directors no relief from liability as directors, and little, if any, scope to adopt decisions that favored the interests of the managing organization over those of the corporation.[265]

France

Board of directors

It is possible to appoint a legal person as a member of the board of directors, if a company has a one-tier board. It is also possible to appoint a legal person as a member of the supervisory board, if a company has a two-tier board (Code de Commerce arts. L. 225-20, 225-76).[266] However, the chairman of these boards must always be a natural person (Code de Commerce, arts. L. 225-47, 225-81). For both systems it is also stated that on their appointment of a legal person

> they must designate a permanent representative, who shall be subject to the same conditions and obligations and who shall incur the same civil and penal liabilities as if they were a director in their own name, without prejudice to the joint liability of the legal personality they represent. Should the legal personality dismiss its representative, it must appoint their replacement at the same time" (Code de Commerce, arts. L. 225-20, 22-76).

As a result, the permanent representative and the legal entity may jointly liable. According to general private law (Code Civil, art. 1992), there may also be liability of the permanent representative against his or her company.

Management

At the level of management, as opposed to the board of directors, there is no express provision for a legal person to serve on the management board for a company with a two tier board. For both the one-tier and two-tier systems, there is also no express provision

265 KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 727 (1999).

266 This is similar to Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE), article 47(1): "An SE's statutes may permit a company or other legal entity to be a member of one of its organs, provided that the law applicable to public limited-liability companies in the Member State in which the SE's registered office is situated does not provide otherwise. That company or other legal entity shall designate a natural person to exercise its functions on the organ in question."

for appointment of a management organization to serve instead of the CEO or the assistant general managers. Since the possibility of a legal person serving on the board of directors is directly addressed in the statute, it may be fairly inferred that a management company cannot serve in these roles. There is also no express provision for the company to hire an individual to manage the company, other than by serving as a CEO. Thus, the question of liability of a managing organization, or an individual manager who is not the CEO, does not arise.

De facto director

The Code de Commerce explicitly includes the concept of a de facto director (*dirigeant de fait*). Under Code de Commerce art. L. 651-2, such a person may be liable to creditors if the firm becomes insolvent and his management errors (*fautes de gestion*) contributed to the insufficiency of assets. Code de Commerce arts. 241-9, 246-2 & 245-16 provide that criminal penalties imposed on directors or managers also apply to a person who manages the firm in fact, under the cover of or in place of its official representatives.

Outside insolvency, the specific provisions of the Code de Commerce on the liability of directors do not apply to de facto directors.[267] However, these persons can be held liable under general civil law.[268]

Germany

Only natural persons can be members of the management board (AktG § 76 III 1) or the supervisory board (AktG § 101 I 1). It is unclear whether a member of the management board may be employed by a third party. In any case, the rights and duties are the same.

There is no express provision in the AktG for the duties of the management board to be exercised by a management company, or by an individual who is not a member of the management board. It may be inferred that these sorts of arrangements are not lawful.

De facto manager

The courts have addressed, in the context of limited liability companies (GmbHs), the situation in which a firm has a de facto manager (faktischer Geschäftsführer), who acts as the managing director of the firm without having an official position. This person must have taken typical management actions which are apparent outside the company.[269] Typically, the de facto manager will be a shareholder of the company, often a controlling shareholder. He will be subject to the same liability rules as the firm's legally appointed managing director.[270] In principle, the same concept should apply in a joint stock company. Courts have found that de facto managers are subject to the duty to file for insolvency and may be liable if they fail to do so.[271] Beyond this, it is not clear what

267 Cass. com. 21-31995, RJDA 7/95, n° 858.

268 FRANCIS LEFEBVRE, MÉMENTO SOCIÉTÉS COMMERCIALES ¶ 1814 (2006).

269 BGH GmbHR 2002, 552.

270 *See for example* Ulrich Haas, in GMBH-KOMMENTAR § 43, ¶ 25 et seq. (Lutz Michalski editor, 2002).

271 BGHZ 104, 44.

duties a de facto manager has. Lutter and Hommelhoff suggest that such a person is not subject to a duty to manage the company, but he is subject to the bookkeeping requirements and has the right (and duty) to convene a shareholder meeting.[272]

Korea

Management of a company by a separate management company is permitted in Korea. In practice, some small companies are managed by a management company, but large companies are not. In theory, members of the management company who are active in managing a company would be considered to be *de facto* directors of the managed company, and should have the same duties and liabilities as the officially elected directors of the managed company.

Concept of De Facto Director

Pursuant to KCC art. 401-2, a third party who is not a director of a company may be held personally liable as a *de facto* director of such company where: (1) such party instructs a director of the company to conduct business by using his/her influence over the company; (2) such party conducts business in person under the name of a director; or (3) such party conducts the business of the company by using a title which may be recognized as authorized to conduct the business of the company, such as honorary chairman, president, director, or others. A *de facto* director is also liable under securities law for damages to investors arising out of false or misleading statements in or material omissions from any public disclosure documents (KSEA art. 8 ¶ 4, art. 14 ¶ 1 No.1-2).

The provisions of the KCC and the KSEA concerning *de facto* directors were adopted fairly recently to address the situation in which the founder of a *chaebol* business group runs the company in fact, even though this person does not officially serving as a director. The scope of the concept of a *de facto* director has not yet been explored by the courts.

United Kingdom

In English law it is possible for a legal person (*e.g.*, Company A) to be director of a company (*e.g.*, Company B). This follows from the general common law assumption that any person can do anything unless it is prohibited or impossible for that person to do it.[273] On occasions proposals have been made to require that directors should be natural persons. Under the new Companies Act 2006, § 155, a company must have at least one director who is a natural person. Other directors may still be legal persons.

The liability of a director who is a legal person is no different in English law than the liability of a director who is a natural person, since there is no provision in the law providing for any differences in liability. Establishing liability may nevertheless be difficult as a practical matter. For example, proving that a corporate director "acted" as a matter of law, rather than the individuals involved in managing the corporate director,

272 MARCUS LUTTER & PETER HOMMELHOFF, GMBH-GESETZ (16th edition 2004), Vor § 35, ¶ 12.

273 See, for example, *Malone* v. *Commissioner for the Metropolitan Police (No. 2)* [1979] Ch. 344.

will be problematic. It will also be problematic to show that the corporate director had a particular mental state, where that is a necessary ingredient of the liability in question.

There are no specific rules governing the liability of the persons who manage the corporate director for a breach of duty to the company of which the corporation is director. This follows from the fact that, so far as company law is concerned, the director is the corporation, and no one else. There may be other sources of law, for example, the law of fraud, that might sometimes provide a basis for finding direct liability on the part of a manager of a corporate director.

There is nothing specifically stated in the Companies Act with regard to a direct delegation by the company of day-to-day management to a separate managing company. Thus, this is probably permitted, subject to the need for the directors to retain sufficient management authority so as not to abdicate their positions and thus violate the duty of care.[274] The managing company would be considered to be an officer, and would have the usual fiduciary duties of an officer. The same issues discussed above for directors would arise, however, for any attempt to find liability on the part of the managing company, or the persons who manage the managing company.

Concept of Shadow Director

English law does not have the concept of an individual manager who is not an officer. A position as an officer, and accompanying fiduciary duties, might well be determined by the actual functions that a person performs. Thus, if a company attempted to set up such a structure, the person who acted as the individual manager would probably be considered to be an officer. Companies Act 1985, § 741 (replaced by Companies Act 2006, § 25) does, however, include the concept of a shadow director, who lacks a formal title but acts as if he were an officer or director, customarily by giving orders to the company's formally appointed officers and directors. In general, shadow directors have the same duties to the company as true directors.

United States

It is possible under Delaware corporate law for the board of directors of a company to engage a management company to conduct day-to-day management, and there are occasional examples where public companies have done so. This managing company will have the same fiduciary duties as a director or officer.

If a managing company was not able to pay damages, assessed as a result of its breach of fiduciary duty, it would be within the discretion of the court to conclude that the managers of the managing company should be considered to be officers of the managed companies and should have personal liability for their conduct, while actually carrying out management tasks. This is because the concept of "officer" is given a functional definition and is not limited to persons who hold an officer title. Thus, this concept, and the associated fiduciary duty, should apply to the persons who in fact are the company's most senior managers. This would be a likely outcome if there were reason to believe

274 See *Lee Panavision* v. *Lee Lighting* [1992] B.C.L.C. 22; Companies Act 2006, §173.

that the management company had been undercapitalized and used as a means to shield the company's de facto officers from personal liability.

Most potential breaches of duty which would give rise to damages would involve the duty of loyalty. For such breaches, if an official of a managing company earned a personal profit, directly or indirectly, and then sought to escape liability by hiding behind the shield of an undercapitalized managing company, one suspects that the courts would have little difficulty either "piercing the corporate veil" and holding the shareholders of the managing company liable for its obligations, or finding direct liability of the individual who was responsible for the breach. In particular, the usual "fraud or wrong" requirement for piercing the corporate veil would be likely to be met. However, there appear to be no cases directly on point.

If an individual acts as a senior manager of a company, that person will be considered to be an officer, and will have the usual fiduciary duties of an officer, regardless of whether this person formally holds the title of an officer.

Turning from company law to securities law, there is some scope for holding a "promoter" of a company liable for harm to investors caused by false or misleading disclosure, even if the promoter is not an officer or director of the company.

Summary and recommendations

The comparison countries provide only limited guidance on the liability of a managing organization, or its directors or senior managers, to the managed company. In several countries, it is not possible for a managing organization to manage a company. In countries where this is possible (U.K. and U.S.), there are not clear rules on the liability of the managing organization or the directors or senior managers of the managing organization, and we are not aware of cases addressing this liability.

In substance, the directors and other officials of a managing organization who adopt decisions on behalf of a managed company are acting as if they were directors or members of the executive organ of the managed company. Thus, we recommend that they have the same duties as they would have if they were officially directors or members of the executive organ of the managed company. More specifically, we recommend the following approach:

General duties of individual manager or managing organization

We recommend that an individual manager, or a managing organization, should have the same duties as a member of the board of directors or a member of the company's executive organ. These include the obligation to act reasonably, in good faith, and in the interests of the company, and the proposed duties of disclosure and confidentiality.

For the obligation to act reasonably and in the interests of the company, and for the proposed duties of disclosure and confidentiality, little more need be said. These duties can apply to an individual manager or a managing organization, in the same manner that they apply to members of the board of directors. For a managing organization, the obligation to be reasonably informed, which forms part of the concept of reasonableness, should be tested against the information available to the persons within the managing organization who adopt decisions on behalf of the managed company.

For the obligation of good faith, it is useful to specify *whose* good faith is relevant, and which other interests should be considered in determining whether a conflict of interest exists. We recommend specifying that the conflicts of interest that are relevant to a determination of good faith include any interests of the individual manager or managing organization, any interests of the persons within the managing organization who adopt decisions on behalf of the managed company, and any interests of other companies that are also managed by the same individual manager or managing organization.

The managing organization should be liable in any circumstance in which the persons within the managing organization, who adopt decisions on behalf of the managed company, would be liable if they were directly directors or members of the executive organ of the managed company. The use of the managing organization should not provide a shield against liability that would not exist if the same persons held positions directly in the managed company.

Liability of directors and officials of the managing organization

As long as there is a sufficient basis for liability of a managing organization for its actions with regard to a managed company, there is not a strong need for direct liability of the directors or other officials of the managing organization who adopt decisions on behalf of a managed company. We nonetheless recommend amending the JSC Law to establish that these persons directly owe the same duties to the managed company which they would have if they were directly directors or members of the executive organ of the managed company. Imposing duties directly is valuable in clarifying the nature of the duties owed by these persons to the managed company. This liability is in addition to the liability of the managing organization.

In addition, if a managing organization is found liable for breach of duty to a managed company and has insufficient assets to pay the damages resulting from this breach of duty, the members of the board of directors, executive organ, or other officials within the managing organization, who adopt decisions on behalf of the managed company, should be secondarily liable (субсидиарная ответственность) for the obligations of the managing organization.

Concept of de facto director

We recommend adoption of the concept, employed in Korea and the United Kingdom, of a shadow or *de facto* director. The United States uses a related concept of "promoter" under securities law. France has the concept of a *dirigeant de fait* (director in fact), who can be liable for the debts of a bankrupt company. Germany uses a similar concept of a *de facto* manager for limited liability companies, and also has complex rules for groups of companies, which provide in some instances for liability of a controlling company for debts of the controlled company (see Chapter 7). If it can be proven that a person has acted in the same manner and with the same practical powers as if this person had been a director of the company or a member of the company's executive organ, this person should be subject to the same duties and face the same potential liability as the company's directors.

There will, of course, be problems of proof in showing that someone has acted as a *de facto* director. But there may also be clear cases, where everyone knows who is running the company in fact. One situation where such proof may be possible would be where a controlling shareholder, or a person acting on behalf of the controlling shareholder, runs the company by giving instructions to the persons who hold official positions in the company's board of directors and its executive organ.

Chapter 6. Liability of directors and managers in the case of bankruptcy

Issue: What additional liability should directors and managers have if the company goes bankrupt? Should a company's directors or managers be liable for failure to inform creditors or shareholders about the company's financial position when it is approaching bankruptcy? If so, what should be the grounds for liability? Should this liability be specifically stated in the law, or is it implicit in the general concept of good faith?

General comment

The discussion below concerns specific statutory or common law grounds for additional liability when a company becomes insolvent. In each of the comparison countries, this additional liability, if it exists at all, is generally based, directly or indirectly, on a specific statutory provision or is part of a specific common law doctrine.[275] It is not considered to be implicit in the concept of good faith.

We do not consider here the potential liability of directors and managers for misrepresenting the company's financial position, under the general tort of misrepresentation.

Russian context

Persons who can be liable

At present, the procedure for bankruptcy in the Russian Federation is regulated by Federal Law #127 of 26 October 2002 -- the Federal Law "On Insolvency (Bankruptcy)" (hereafter "Bankruptcy Law") and Federal Law #40 of 25 February 1999 -- the Federal Law "On Insolvency (Bankruptcy) of Credit Organizations."

Under existing legislation, it is possible to hold both the manager and the members of its board of directors of a debtor company liable for violating the Bankruptcy Law. The manager of a debtor is the single-person executive organ of a legal entity or the manager of a collegial executive organ as well as any other person acting -- in accordance with federal law -- in the name of a legal entity without power of attorney (e.g., a managing organization or a manager) (Bankruptcy Law art. 2). The liability of the manager of a debtor is secondary to that of the debtor. Under Civil Code art. 399, the manager's

275 In Germany, the statutory basis is indirect. Directors of an insolvent company are required to file for bankruptcy under AktG § 92. If they fail to do so, they are liable to creditors under the general law of torts (German Civil Code § 823(2)), rather than directly under the AktG.

secondary liability arises if the primary debtor refused to satisfy the creditor's demand or the creditor has not received a response in a reasonable period to a demand made of the primary debtor.

Bases for liability

The persons responsible for a violation of the Bankruptcy Law are liable to the debtor for incurred losses (Bankruptcy Law art. 10(1)). The Bankruptcy Law has a strongly prescriptive character, with an extensive list of potential violations. Thus, for example, the manager of a debtor must provide the claims administrator -- within three days from the date of his appointment -- all accounting documentation of the debtor, seals, stamps and so on (Bankruptcy Law art. 126(2)).

Bankruptcy Law art. 10(2) establishes the secondary liability of a manager for failing to submit the declaration of a debtor to the court, or failing to submit it within the time period specified in the law. Bankruptcy Law art. 9 lists the cases in which the manager of a debtor must submit a declaration of bankruptcy to the court. The debtor's declaration should be submitted within one month from the occurrence of the circumstances that require the declaration. The manager is directly liable to the creditors, rather than to the company itself.

Secondary liability of a manager for bankrupting a debtor

Bankruptcy Law art. 10(4) provides for secondary liability for the bankruptcy of a debtor which is caused by the actions of persons who have the right to give mandatory instructions to the debtor or to determine its actions in some other manner. An analogous rule is established in Civil Code art. 56(3) and JSC Law art. 3(3). A condition of liability in the given case is the presence of fault in the manager's action or inaction.[276]

Problems in Establishing a Manager's Liability in the Bankruptcy of a Company

In spite of the considerable range of actions for which a manager of a bankrupt company can be held liable, judicial precedents are scarce. There have been some efforts by creditors seeking to hold the manager liable, and sometimes the company's shareholders as well. In practice, however, plaintiffs are often incapable of providing sufficient evidence against a manager, even though the insolvency administrator has complete access to the debtor's financial and other documents.

One problem is establishing a causal relationship between the action or inaction of the debtor's manager (or other persons having the right to give mandatory instructions to the debtor) and the resulting bankruptcy or losses. In Russian judicial practice, establishing a cause-and-effect relationship can be exceptionally complicated. Courts often dismiss a suit solely on this basis.[277] For example, even if the manager's actions caused losses, the highest courts have stated that "the court should consider that the persons (manager and

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276 Decision of the Federal Arbitrazh Court of the Moscow District No. KG-A40/3464-04 (May 18, 2004), (Постановление Федерального Арбитражного суда Московского Округа от 18 мая 2004 г. N КГ-А40/3464-04).

277 See, for example, Decision of the Federal Arbitrazh Court of the Eastern-Siberian District No. A19-6575/03-13-F02-4590/03-S2 FAC (Dec. 23 2003), (Постановление Федерального Арбитражного Суда Восточно-Сибирского Округа от 23.12.2003, № А19-6575/03-13-Ф02-4590/03-С2 ФАС).

so on) can be held secondarily liable only in those cases when the bankruptcy of a legal entity was brought about by their directions or other actions".[278] Managers often maintain that the bankruptcy of the company began long before the challenged actions and that their actions thus were not the cause of the bankruptcy. Proving that a particular action caused the company's bankruptcy is extremely difficult. Substantiating the fact that the manager's failure to timely submit a declaration of bankruptcy to the court was the cause of losses is even more difficult.

A second large problem is establishing the fault of the manager, which is an essential condition for liability (Bankruptcy Law 10(4)). The judicial precedents we examined show that courts often do not accept the proof of the defendant's fault presented by the plaintiff. The court rarely provide a detailed explanation of the reasons for finding that the defendant was not at fault. Thus in particular cases the following evidence of the defendant's guilt was not treated as sufficient:: the conclusion of an expert as part of a bankruptcy case,[279] the decision of a court and the conclusion of an authorized government body in the area of bankruptcy oversight about signs of a deliberate bankruptcy,[280] and so on. In addition, although the Bankruptcy Law require only ordinary civil law fault, and not intent, in a number of judicial decisions, the court has cited the need to establish that a persons having the right to give orders to the debtor obviously knew that the bankruptcy of the company would result as a consequence of their actions.[281]

The Arbitrage Procedure Code imposes upon the plaintiff the obligation to establish guilt and a cause-and-effect relationship. At present, there is discussion of possible amendments to the Law on the Bankruptcy of Credit Organizations which would impose an obligation upon the bank manager to establish his own lack of fault (see the section below on the bankruptcy of credit organizations). It could make sense to amend the Bankruptcy Law in an analogous manner.

Problems in Determining the Extent of Claims for Compensation

Plaintiffs also confront problems in determining the extent of their claims for compensation. First, on several occasions the previous manager has destroyed financial

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278 Joint Decision of the Plenum of the Supreme Court of the Russian Federation and the Plenum of the Supreme Arbitrazh Court of the Russian Federation, No. 6/8 /On Several Questions Connected with the Use of the First Part of the Civil Code of the Russian Federation/ (July 1, 1996) (Совместное Постановлении Пленума Верховного Суда Российской Федерации и Пленума Высшего Арбитражного Суда Российской Федерации от 1 июля 1996 года № 6/8 «О некоторых вопросах, связанных с применением части первой Гражданского кодекса Российской Федерации»).

279 Decision of the Federal Arbitrazh Court of the Moscow District No. KG - A40/9993-05 (Oct. 18, 2005), (Постановление Федерального Арбитражного Суда Московского Округа от 18 октября 2005 г. N КГ-А40/9993-05).

280 Decision of the Federal Arbitrazh Court of the Moscow District No. KG - A40/23-04 (Feb. 11, 2004) (Постановление Федерального Арбитражного Суда Московского Округа от 11 февраля 2004 г. N КГ-А40/23-04).

281 See, for example, Decision of the Federal Arbitrazh Court of the Volga District No. A12-10359/02-S32 (Mar. 27, 2003) (Постановление Федерального Арбитражного Суда Поволжского Округа от 27 марта 2003 г., N А12-10359/02-С32).

documents which could bear witness to his guilt, thus also complicating the issue of determining the amount for which the manager is potentially liable. Current legislation does not provide effective countermeasures against this type of evasion. Managers are liable for ensuring the safe-keeping of documents, but holding a manager liable for their loss requires, in any case, that the amount of damages and his guilt be established (see, for example, Russian Code of Administrative Violations art. 26.1). This is extremely difficult and often impossible, for example, in a case where a manager files a fictitious report of stolen documents with the police, etc.

Even where the insolvency administrator has access to the company's documents, serious problems can arise in proving losses. Thus, for example, in one of the rare cases in which a decision found a defendant manager of a bankrupt company liable, the court considered it essential to limit the extent of liability, observing that the defendant's actions "were not the only ones which resulted in the company's insolvency."[282] This resulted in a more than three-fold reduction in damages, relative to the plaintiff's original demand. In our view, this decision is incorrect. Bankruptcy Law art. 129(5) clearly defines the extent of secondary liability, and a literal interpretation of this provision does not give the court any basis for reducing the amount of damages. However, most of the judicial decisions we examined follow the given example in determining the extent of liability.[283]

The Right to Submit a Claim

Under Bankruptcy Law art. 129(5), the insolvency administrator has the right to submit a claim seeking secondary liability under Bankruptcy Law art. 10(4). The law, however, does not directly state that the given right belongs exclusively to him. Thus, creditors have also tried to bring claims under Bankruptcy Law art 10(4). The courts initially held that only claims administrators can present demands for secondary liability.[284] Subsequently, however, the Supreme Arbitrazh Court modified its view and explained that a creditor can submit a claim of secondary liability, but only "in those cases where the indicated persons were not held secondarily liable" by the claims administrator.[285]

282 Decision of the Federal Arbitrazh Court of the Moscow District No. KG-A40/10958-05-P, 10958-05-P-2 (Nov. 18, 2005) (Постановление Федерального Арбитражного Суда Московского Округа от 18 ноября 2005 г., N КГ-А40/10958-05-П, 10958-05-П-2).

283 See, for example, Decision of the Federal Arbitrazh Court of the Moscow District No. KG - A40/9993-05 (Oct. 18, 2005) (Постановление Федерального Арбитражного Суда Московского Округа от 18 октября 2005 г. N КГ-А40/9993-05); Decision of the Federal Arbitrazh Court of the Moscow District No. KG - A41/4527-04 (Jun. 15 2004) (Постановление Федерального арбитражного суда Московского Округа от 15 июня 2004 г. N КГ-А41/4527-04); Decision of the Federal Arbitrazh Court of the Volga District No. A12-20416/03-S35 (Jun. 15, 2004) (Постановление Федерального Арбитражного Суда Поволжского Округа от 15 июня 2004 г. N А12-20416/03-С35).

284 Joint Decision of the Plenum of the Supreme Court of the Russian Federation and the Plenum of the Supreme Arbitrazh Court of the Russian Federation, No. 6/8 "On Several Questions Connected with the Use of the First Part of the Civil Code of the Russian Federation" (Jul. 1, 1996) (Совместное Постановлении Пленума Верховного Суда Российской Федерации и Пленума Высшего Арбитражного Суда Российской Федерации от 1 июля 1996 года № 6/8 «О некоторых вопросах, связанных с применением части первой Гражданского кодекса Российской Федерации»).

285 Decision of the Supreme Arbitrazh Court of the Russian Federation No. 29 "On Some Issues of the Practice of the Application of the Federal Law on Bankruptcy" (Dec. 15, 2004) (Постановление Высшего

Thus, if a claim administrator’s suit to hold the company's executive organ liable was denied by a court, then a creditor cannot refile a similar suit against this organ.

In contrast, creditors have a stronger need to be able to submit a claim for secondary liability under Bankruptcy Law art. 10(2), if the debtor's managers fail to file a declaration of insolvency or fail to do so timely. The law in this case does not directly specify the persons who have the right to submit a claim, and there are no judicial decisions on this issue.

Specifics of Liability for the Bankruptcy of Credit Organizations

The bankruptcy proceedings of credit organizations are regulated separately under Russian law. The Bankruptcy Law and the Bankruptcy Law of Credit Organizations have a lot in common in their approach to the liability of the managers of the bankrupt company. In addition, if a given issue is not regulated by the Bankruptcy Law of Credit Organizations, the Bankruptcy Law governs.

The manager and/or members of the board of directors of a credit organization bear secondary liability for the organization's obligations if they caused its bankruptcy. Moreover, if these persons are found to be liable, a court can divest them of their right to occupy management positions in credit organizations.

Managers of credit organizations face additional duties, in addition to those to managers of other companies, to monitor the organization’s financial condition and take actions if the organization is in financial difficulty. Thus, for example, if circumstances emerge involving the risk of the credit organization’s insolvency, a manager must, within 10 days, present to the organization's board of directors proposed measures for the organization's financial recovery recommendations about the form, nature and timeline of the financial recovery. The manager and the board of directors are obligated to inform the Bank of Russia about any decisions made connected with the organization's financial recovery. If any of these obligations is not fulfilled, the manager can be held secondarily liable if the bankruptcy of the credit organization is a result of this failure. However, problems of proof arise which are similar to those discussed above under the Bankruptcy Law. In practice, we are not aware of decisions holding the manager or members of the board of directors of a credit organization secondarily liable during its bankruptcy.

At present, draft revisions to the Bankruptcy Law of Credit Organizations have been prepared, under which the manager of a credit organization will be denied the “presumption of innocence” and will thus be forced to prove his lack of fault in court once a bankruptcy occurs.

Conclusion: Current bankruptcy legislation does not provide the possibility to effectively hold liable the manager and other management organs of a debtor, for at-fault actions which cause losses to an insolvent company, or cause its insolvency.

Арбитражного Суда Российской Федерации от 15 декабря 2004 г. N 29 «О некоторых вопросах практики применения ФЗ «О несостоятельности (банкротстве)»).

Canada

The CBCA and other Canadian corporate statutes provide several methods by which a corporation can be terminated. However, if a corporation is being terminated due to insolvency, the corporate law procedures cannot be used (e.g. CBCA § 208). The corporation must instead be liquidated pursuant to federal legislation directed specifically to insolvency, either the Bankruptcy and Insolvency Act or the Winding Up Act.[286] Practically speaking, the Bankruptcy and Insolvency Act is the more important of the two for public companies, so the discussion below will focus only on this legislation.

When a corporation is terminated under the Bankruptcy and Insolvency Act, a trustee in bankruptcy will be appointed by a court. The trustee can enforce, on behalf of the company, any claim the company may have, including a claim against directors (Bankruptcy and Insolvency Act § 30(1)(d)). This has significant practical implications. Since a trustee in bankruptcy will be independent of company management and will owe duties to the company's creditors, the trustee is more likely to enforce a claim the company has against directors than is the company's incumbent board. It is also likely to be the case, at least on average, that the grounds for such a claim will be more likely to be present when a company has gone bankrupt.

Thus, while in a sense the ability of the trustee to bring claims against the directors does not impose new duties or liabilities on directors, it gives teeth to the duties and liabilities that already exist.

It is unclear whether a trustee in bankruptcy can rely on the oppression remedy to pursue claims against directors.[287] On one hand, the bankruptcy trustees could have standing, since the courts have discretion to allow an oppression claim to be brought by any person they deem to be "proper." Courts have often deemed creditors to be eligible to bring oppression claims, and this permission might carry over to the bankruptcy trustee, who is acting on the creditors' behalf. On the other hand, in theory, a bankruptcy trustee only succeeds to the rights of the bankrupt corporation. As a matter of logic, it is difficult to see how a corporation can seek relief for what is, in effect, its own oppressive conduct.[288]

The Bankruptcy and Insolvency Act also provides the bankruptcy trustee with causes of action against the directors of the bankrupt corporation, in addition to those available under corporate law and other laws. For instance, if a corporation declared a cash dividend or repurchased shares for cash within a year of being declared bankrupt and was insolvent at the time it did so, a court can award judgment against the directors for the amount of the dividend or the amount paid to repurchase shares. A director will not be liable if he can establish he had reasonable grounds for believing the corporation was not

286 J. ANTHONY VANDUZER, THE LAW OF PARTNERSHIPS AND CORPORATIONS 388 (2nd edition, 2003).

287 MARKUS KOEHNEN, OPPRESSION AND RELATED REMEDIES 33-34 (2004); MCCARTHY TETRAULT, DIRECTORS' AND OFFICERS' DUTIES AND LIABILITIES IN CANADA 248-249 (1997). The "unfair prejudice" or "oppression remedy is discussed in earlier chapters.

288 *Canada (Attorney-General) v. Standard Trust Co*. (1991) 5 Ontario Reports (3d) 660.

insolvent at the time of the relevant transaction (Bankruptcy and Insolvency Act § 101).[289]

The Bankruptcy and Insolvency Act also authorizes a trustee in bankruptcy to challenge transactions occurring within twelve months of the date of bankruptcy where the parties were not dealing at arm's length or were "related". If the transaction occurs at a "conspicuous" difference from fair market value, the court may award judgment to the trustee against the other party to the transaction or against any other person "privy to the transaction with the bankrupt," for the difference between fair market value and the actual consideration given or received by the bankrupt corporation (Bankruptcy and Insolvency Act § 100). A director who is a direct party to this sort of reviewable transaction runs a clear risk of being sued by the bankruptcy trustee. A director may also qualify as "privy to the transaction" if the director has an indirect interest in a challenged transaction.[290]

For directors of bankrupt companies, potential liability for unpaid wages is a source of potential concern. This source of additional liability is discussed in an earlier chapter.[291]

Directors do not have an affirmative duty to cause their company to inform shareholders or creditors of the company's financial position as it approaches insolvency. However, a director who misrepresents the company's financial condition may be liable to persons injured under the tort of misrepresentation.[292] Public companies also have obligations under securities legislation, which imposes continuous disclosure requirements. Compliance with these requirements will sometimes, as a practical matter, provide some information to investors about a company's weakening financial position.

Some Canadian text-writers have speculated directors might owe a duty directly to persons with a direct or indirect interest in a company where the director knows or reasonably ought to know that unlawful loss is likely to be caused to that person by the way in which the directors are causing the company to be managed.[293] If Canadian courts were to recognize such a duty, it potentially could provide a foundation for a duty to disclose details of impending bankruptcy.

France

An insolvent company must apply for the commencement of the insolvency or reorganisation procedures no later than 45 days after becoming insolvent (Code de Commerce, arts. L. 631-4, 640-4). Failure to timely apply may lead to directors' liability if the court finds that management mistakes (*fautes de gestion*) contributed to the

289 MCCARTHY TETRAULT, DIRECTORS' AND OFFICERS' DUTIES AND LIABILITIES IN CANADA 241-242 (1997).

290 MCCARTHY TETRAULT, DIRECTORS' AND OFFICERS' DUTIES AND LIABILITIES IN CANADA 244-246 (1997).

291 See Chapter 1.6 of this Report.

292 KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 811 (1999).

293 KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 945 (1999).

insolvency (Code de Commerce art. L. 651-2). This liability can be enforced by the creditor's representative, the insolvency administrator, or a majority of the creditors (Code de Commerce art. L. 651-3). The details of liability depend on whether the company is reorganized or liquidated. This is summarised by Paul Omar as follows:

> (The) liability for all or part of business debts (…) contains a general element, available in cases of liquidation and where a rescue plan (whether adopted in the context of preservation or judicial rescue proceedings) comes to an end prematurely by default, as well as a specific element, referable to specific instances of fault, only available in instances of liquidation proceedings. The logic behind this move is that claims for a contribution [by directors] are to be deemed incompatible with judicial rescue . . . because the adoption of a rescue plan, which provides normally for the settlement of all claims, should see creditors satisfied.[294]

Germany

Upon the opening of the insolvency proceedings the debtor's right to manage and transfer the assets involved in the insolvency proceedings are vested in the insolvency administrator (Insolvency Law (InsO) § 80). Thus, company officials will usually not become liable during the period of insolvency because they do not manage the company any more.

The more important period is before the insolvency proceedings start. This is addressed in AktG § 92: In case of either balance sheet insolvency (assets less than liabilities) or illiquidity (inability to timely pay creditors), directors are required to call an extraordinary general meeting, apply for insolvency proceedings, and make only payments that are compatible with the diligence of an orderly and conscientious manager. The most important duty is the obligation to file for insolvency without culpable delay, but no later than three weeks after the occurrence of the inability to pay. If directors fail to meet these duties, in particular the duty to file for insolvency without undue delay, they may become liable under general principles of tort law for negligence in failing to do so. Typically, the insolvency administrators will bring claims on behalf of the company.[295] There may also be liability in favour of creditors based on tort law,[296] since the creditors will often be harmed by the delay in filing for insolvency, and some creditors would not have advanced funds to the firm if it had filed for insolvency at an earlier date.

294 Paul J. Omar, *French Insolvency Law and the 2005 Reforms*, 16 INTERNATIONAL COMPANY AND COMMERCIAL LAW REVIEW 490 (2005), at 498.

295 *For example*, UWE HÜFFER, AKTIENGESETZ § 92 ¶ 15 (7th edition, 2006).

296 BGHZ 29, 100, 103 = NJW 1959, 623; BGHZ 75, 96, 106 = NJW 1979, 1823 [*Herstatt*]; BGHZ 100, 19, 21 = NJW 1987, 2433 f; BGHZ 126, 181, 190 = NJW 1994, 2220. For a detailed comparison of German *Insolvenzverschleppungshaftung* and the English wrongful trading remedy, see Thomas Bachner, *Wrongful Trading – A New European Model for Creditor Protection*, 5 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW *293* (2004).

Finally, in the case of a "crisis" (which does not necessarily mean the company is insolvent), judicial decisions indicate that loans given by shareholders to the company may be subordinated to other debts of the company under the so-called "law of equity substitution" (*Kapitalersatzrecht*). If a corporation is considered to not have been "creditworthy"[297] or is considered to have been in a "crisis"[298] when the shareholder loan was made, the loan may not be repaid until stated capital is fully paid up.[299] If the directors authorize payments that contravene these rules were made, and the payments cannot be recovered from shareholders, the directors will be liable.

Korea

A director may be held criminally liable when he or she is implicated in the company's fraudulent and/or negligent bankruptcy and the declaration of the bankruptcy against the debtor becomes final. Similarly, a director may be criminally liable when he or she is implicated in the fraudulent and/or negligent reorganization of the company. Korean Bankruptcy Act art. 643 ¶ 2 No. 2.

In Korea, a bankruptcy administrator can enforce claims against directors of the insolvent company on behalf of the company, including claims for breach of duty under company law. The administrator may ask the court to seize the directors' assets to secure the damages claim. Korean Bankruptcy Act art. 401-2 ¶ 1, art. 351 ¶ 1.

Finally, as mentioned in a previous chapter, the Korean Deposit Insurance Corporation often pursues litigation against the directors of bankrupt financial institutions pursuant to Korean Depositor Protection Act art. 21-2.

There is no obligation on the part of directors to place a company into bankruptcy proceedings, nor liability for failing to inform creditors about the company's financial condition.

United Kingdom

When a company becomes insolvent, its affairs are taken over and run by an official known either as an "administrator" or a "liquidator", depending on the type of insolvency proceedings. Very broadly, administration is used either to ensure preservation of the value of the company's ongoing business and assets, or where there is some hope that the company may emerge from insolvency, whereas liquidation is undertaken with a view to terminating ("winding up") the company. There is also a procedure, currently being largely phased out, called "administrative receivership", whereby a secured creditor can

297 Compare Peter Hommelhoff, *Grundstrukturen im Recht des Eigenkapitalersatzes*, in HANDBUCH DES KAPITALERSATZES ¶ 1.8 (Hartwig von Gerkan and Peter Hommelhoff editors, 2002).

298 *See* UWE HÜFFER, AKTIENGESETZ § 57, ¶ 16 (7th edition, 2006). The term "crisis" is used in the law on limited liability companies, GmbHG § 32a Abs 1. The principles developed in the case law apply to both joint stock companies and limited liability companies.

299 See Peter Hommelhoff, *Grundstrukturen im Recht des Eigenkapitalersatzes*, in HANDBUCH DES KAPITALERSATZES ¶ 1.9 (Hartwig von Gerkan and Peter Hommelhoff editors, 2002).

enforce his security interest. This procedure is technically not regarded considered to be an insolvency proceeding, though it functions in a similar way.

The most important point to remember is that a liquidator or administrator or administrative receiver can enforce on behalf of the company (or cause the company to enforce) any claim the company may have against a company official under the general law irrespective of insolvency. This means that any breach of a director's duty, owed to the company, can be enforced by a liquidator, administrator or administrative receiver. Such individuals, being independent of company management and owing duties to the company's creditors, are more likely to enforce any claim the company may have against directors than is the company's incumbent management. Thus, as in Canada, even if the duties of directors are the same, the practical risk they face increases substantially if the company becomes insolvent. A liquidator who enforces a claim that the company has against a director may, but does not have to, use a special expedited enforcement procedure (Insolvency Act 1986, § 212).

Directors are not liable for failing to inform creditors as the company is approaching insolvency. However, they are liable for failing to cause the company to enter insolvency on a timely manner. There are two relevant provisions:

- Under Insolvency Act 1986, § 213, a liquidator can apply to the court to declare a director or anyone else liable to contribute to the assets of the insolvent company for continuing to carry on the business of the company with intent to defraud creditors of the company or of any other person. This action is quite broad – it can be brought against anyone – and the potential liability is unlimited. However, it requires proof of *intent to defraud*. This means that the action is not widely utilized.
- Under Insolvency Act 1986, § 214, a liquidator can petition a court to rule that the company's directors have engaged in "wrongful trading" and therefore should contribute to the assets available to creditors. A director engages in wrongful trading if (i) the company is in liquidation; (ii) before liquidation, he knew or ought to have concluded there was no reasonable prospect that it would avoid this fate; and (iii) he failed to take every step a reasonably competent director would have taken to minimize the creditors' potential loss. If a director is held liable for wrongful trading, the court has discretion to order him to contribute to the assets of the company, though the court will customarily exercise this discretion so as to make the director pay only the amount of extra liability incurred by the company through his wrongful trading:[300]

As a result, directors of a company in financial distress would be well advised to cause the company to enter insolvency proceedings before it is fully insolvent. This early filing will reduce their risk of later being found liable for wrongful trading. This filing will provide effective notice to creditors of its financial position.

Three other provisions of the Insolvency Act 1986 are less important, but deserve brief mention. These provisions are not specifically aimed at directors, but would cover

300 *Re Produce Marketing Consortium Ltd. (No. 2)* [1989] BCLC 520.

transactions between the company and its directors. Only transactions within a certain period prior to insolvency can be challenged under these provisions. This period is extended where the defendant is a director or someone "associated" with a director, such as a spouse (Insolvency Act 1986, §§ 249, 435). The extension is from six months before the company becomes insolvent to two years for §§ 238-239, and from 12 months to 2 years for § 245.

- Under Insolvency Act 1986, § 238 ("transactions at an undervalue"), a transaction at an undervalue (the company received less than fair value when selling assets, or paid more than fair value for assets) made by a company shortly prior to insolvency can be reversed, either directly, or in effect by the award of damages. There are protections for innocent purchasers and good faith transactions.
- Under Insolvency Act 1986, § 239 ("preferences"), a transaction which is intended to put one unsecured creditor of the company in a better position than others can be reversed, so that the payment is returned to the company and is available to all creditors. There is protection of innocent recipients of payment, such as trade creditors.
- Under Insolvency Act 1986, § 245 ("avoidance of floating charges"), a security interest granted by a company over its undertaking (which is similar to a general security under the U.S. Uniform Commercial Code) can be set aside if it was not granted in exchange for new consideration.

United States

In the United States, there are no specific statutory or common law grounds for suits against directors under bankruptcy or insolvency law which would not be available for solvent companies. There is no obligation to inform creditors if the company is approaching insolvency, and no obligation to enter insolvency proceedings if the company becomes insolvent.[301] There was, for a time, some discussion in a few opinions of potential liability for actions that cause the "deepening insolvency" of a company. However, a recent Delaware case directly rejects this source of liability.[302] It is up to creditors to begin insolvency proceedings if they have not been paid. However, as in other countries, the practical risk faced by directors increases substantially.[303]

One source of concern is that if a company is insolvent, the goal to be attained through the directors' exercise of their fiduciary duty of care shifts from maximizing the value of the firm's business to shareholders to maximizing that value to creditors. As a result,

301 See Henry T. C. Hu & Jay L. Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUMBIA LAW REVIEW 1321 (2007).

302 See Trenwick America Litigation Trust v. Ernst and Young, LLP , 2006 Del. Ch. LEXIS 139 ("Delaware law does not recognize the term 'deepening insolvency' as a cause of action . . . ."); for discussion of earlier cases see Sabin Willett, *The Shallows of Deepening Insolvency*, 60 BUSINESS LAWYER 549 (2005).

303 See Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STANFORD LAW REVIEW 1055-1159 (2006), at http://ssrn.com/abstract=894921.

decisions that favor shareholders over creditors, such as taking business risks where failure would increase the losses suffered by creditors, could be attacked by creditors. Moreover, it is often unclear when a company has become insolvent. Thus, the directors of a financially troubled company may be unsure to whom their duties are owed.[304]

At the same time, the practical import of this shift in the directors' goals under the duty of care is limited. Recall from an earlier chapter that all directors are protected by the business judgment rule, and the outside directors of most public companies are totally protected against monetary liability for breach of the duty of care as long as they act in good faith. While it is possible that actions that assist shareholders at the expense of creditors could be claimed to be not in good faith, as a practical matter, one would expect the courts to insist on strong proof that a director knew the company was insolvent, and knew that his action would harm creditors, before finding lack of good faith and therefore imposing monetary liability on an outside director.

To quote from a recent assessment of outside directors' risk:[305]

> Insolvency adds a distinctive dynamic to litigation based on an allegation of a breach of duty by directors: the potential for a suit to be brought by bankruptcy trustees, creditors' committees, and liquidation trustees. These are suits based on a breach of fiduciary duty to the corporation and are brought in the name of the corporation.[306] The recovery, if any, goes to the corporate estate for the ultimate benefit of creditors. After some confusion in various courts, the Delaware Chancery Court has ruled that in these cases outside directors have the protection of exculpatory charter provisions, authorized by section 102(b)(7) and the business-judgment rule, just as they do in shareholder derivative suits.[307] Consequently, fiduciary duty suits initiated by creditors on behalf of the bankrupt estate should not differ greatly from derivative suits brought by shareholders,[308] meaning outside directors sued on the basis of a breach of loyalty face a risk of paying out of their own pockets, but those being sued for a failure to exercise sufficient oversight face very little risk.
>
> Procedurally, outside directors have less protection in these suits than they do in shareholder suits. There is no demand requirement and no special litigation

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304 See Rutherford B. Campbell & Christopher W. Frost, *Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)* (working paper 2006), at http://ssrn.com/abstract=900904.

305 Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STANFORD LAW REVIEW 1055-1159 (2006), at 1092-1093, at http://ssrn.com/abstract=894921.

306. Production Resources Group, LLC v. NCT Group, Inc., 863 A.2nd 772, 792 (Delaware Chancery Court,. 2004).

307. *Id.* For cases illustrating the division of opinion in the courts prior to *Production Resources*, see *Continuing Creditors' Committee of Star Telecommunications v. Edgecomb*, 385 F. Supp. 2nd 449 (D. Del. 2004); *Pereira v. Cogan*, No. 00-CIV.-619(RWS), 2001 WL. 243537 (S.D.N.Y. Mar. 8, 2001) (applying Delaware law); *In re Ben Franklin Retail Stores, Inc.*, No. 97C7934, 2000 WL. 28266 (N.D. Ill. Jan. 12, 2000) (applying Delaware law).

308. Pereira v. Farace, 413 F.3d 330 (2nd Cir. 2005).

> committee in creditor suits. Thus, if the merits of a case against the outside directors are strong, creditor-initiated breach-of-duty cases pose a greater threat of at least nominal liability than do shareholder suits where the company is solvent. Nonetheless, our search [for cases involving personal payments by outside directors, not covered by directors and officers liability insurance] turned up only one [settled] case in which an outside director has made an out-of-pocket payment in litigation of this sort.

Summary and recommendations

Russia's Bankruptcy Law has been recently amended, and includes specific provisions that relate to the liability of a company's directors and managers, including their obligation to return "preference" payments, which the company made to them within a specified period prior to insolvency. A company's directors and managers are also liable for transactions that they complete which remove assets from the company, without providing fair value in return, thus depleting the value available to creditors. In addition, the company's general director (all directors in the case of a bank) has subsidiary liability to the company's creditors if the company is insolvent but fails to enter insolvency proceedings.

It is beyond the scope of this Report to recommend changes to the Bankruptcy Law. We believe that the Bankruptcy Law is the proper law to prescribe specific duties of directors and managers of a company in the case of insolvency. Thus, we do not recommend amending the JSC Law to provide for additional liability of directors or managers, beyond that already provided for in the JSC Law and the Bankruptcy Law. It may, however, be worth explaining why we do not recommend imposing additional duties on directors and managers of an insolvent company.

Several of the comparison countries impose liability on directors for allowing the company to continue its operations, without filing for insolvency, when it has become insolvent. We do not recommend this approach for Russia. One important reason not to impose liability on a firm's directors and managers for not taking action as a firm approaches bankruptcy is that it can be hard to know when a firm becomes insolvent. A director who is otherwise careful and diligent should not be liable for guessing wrong about when a company has become insolvent. Nor should directors be liable because they had a different opinion than a reviewing judge about when a company became insolvent. A business judgment rule defense provides only partial protection, especially when the company is insolvent and cannot indemnify the director for legal expenses.

Also, a firm's directors already often face substantial losses as a firm approaches bankruptcy, on their own holdings of shares. In many cases, it will be better for a company that is in financial distress if its outside directors remain in their positions. Yet, if these persons face additional liability, they will be tempted to resign at the early signs of trouble.

An important issue is which court has jurisdiction to hear disputes involving the liability of the directors and managers of an insolvent company. At present, there is no specific statement on this issue in the JSC Law or the Bankruptcy Law, so general rules of jurisdiction apply. We recommend that the arbitrazh courts, which already have jurisdiction over bankruptcy cases, should also have jurisdiction over these disputes.

A different issue is whether directors should be liable for affirmatively concealing the company's financial position from creditors. A typical loan agreement with a bank or other major creditor requires the company to report its financial position periodically to creditors. Directors who knowingly заведомо зная) provide false reports to creditors, or knowingly delay providing reports which would indicate the firm's troubles and provide a basis for creditors to themselves push the company into insolvency proceedings, might appropriately be liable for these actions.[309] However, the proper location for this liability is the Bankruptcy Law, not the JSC Law.

Chapter 7. Particularities of liability for actions in respect of subsidiary and dependent companies

Issue: Should a parent company, or members of the management organs of a parent company, be liable for their actions and decisions in connection with the management of a subsidiary or dependent company? If yes, what are the specific features of this liability?

Russian context

Under JSC Law art. 6(2), a company is deemed to be a *subsidiary company* if another (principal) economic entity (partnership), due to its predominant participation in such company's charter capital or under a contract made between them or otherwise, may determine the decisions approved by such company. Under JSC Law art. 6(4), a company is deemed to be *dependent* if another (predominant) company holds more than 20% of the voting shares of the former company. The predominant company, due to ownership of a significant block of shares, can often influence the dependent company's decision-making, but it does not have the right to give the latter mandatory instructions.

Civil Code art. 105 and JSC Law art. 6 specify when a principal entity can be liable for its actions with respect to a subsidiary company. The following are possible, we consider each below in turn:

- A suit by creditors to hold the principal entity liable for the debts of the subsidiary company.
- A suit by the subsidiary company or its shareholders to hold the principal entity liable for losses caused through its fault due to the subsidiary company complying with the principal entity's mandatory instructions to the subsidiary company (JSC Law art. 6(3)).

309 For a U.S. example of delayed reporting, see SEC Files Settled Charges Against Eight Former Officers and Directors of Spiegel, Inc. (Securities and Exchange Commission press release, Nov. 2, 2006).

- Secondary liability in a suit by creditors or an insolvency administrator if the bankruptcy of the subsidiary company occurred through the fault of the principal entity.

If the principal entity is found liable for actions relating to a subsidiary company, the principal entity or its shareholders can then bring an action seeking to hold liable the members of the management organs of the principal entity whose actions or decisions led to this liability.

The shareholders of the subsidiary company (independently of the number of shares that they possess) have the right to demand compensation from the principal entity for losses caused through its fault to the subsidiary company .

Conditions for Holding the Principal Entity Liable

We next discuss the principal elements of liability on the part of a principal entity.

1. The first element is the presence of "holding relations" between the principal entity and the subsidiary company, within the meaning of Civil Code art. 105(1) and JSC Law art. 6(2). "Holding relations" are relations by virtue of which the principal entity may determine the decisions of the subsidiary company independently of whether other types of economic dependence are present. Thus, for example, courts have refused to establish the presence of holding relations if only civil-legal contracts exist between a principal entity and a subsidiary company or employer-employee relations between managing employees of the companies, or where the principal entity holds shares in the subsidiary indirectly, through an intermediary company or companies. These forms of influence are not considered sufficient to satisfy the requirement that the principal entity have the power to give binding instructions to the subsidiary.

Under JSC Law art. 6(3), a principal entity can be secondarily liable for the debts of the subsidiary company only if there is an explicit grant -- in the subsidiary's charter or in a contract concluded with it -- to the principal entity of the power to give orders to the subsidiary company. In practice, in order to prevent potential liability, principal entities often conceal their control over the activities of the subsidiary company. They have control in fact, but not formal control through a charter provision or a contract. As a result, the interests of the subsidiary company remain unprotected. In an effort to avoid this outcome, and despite the clear requirements of JSC Law art. 6(3), some courts have reached the conclusion that a principal entity has the right to give mandatory instructions to a subsidiary unless the subsidiary's charter or a contract between the companies contains a direct prohibition against the giving of such instructions.

2. The second element is that the subsidiary must have concluded transactions in fulfillment of the mandatory instructions of the principal entity, which led to losses to the subsidiary.[310] In principal, the need for this to be shown is clear. In practice, however, proving that a specific transaction was completed in fulfillment of the mandatory instructions of the principal entity is rather complex. The judicial precedents examined

310 See, for example, Decision of the Federal Arbitrazh Court of the Volgo-Vyatskiy District No. A43-1231/98-7-51 (Aug. 26, 1998) (Постановление Федерального Арбитражного Суда Волго-Вятского Округа от 26.08.1998, № А43-1231/98-7-51).

show that courts often limit themselves to establishing the presence of holding relations and then hold the principal entity jointly liable together with the subsidiary company, without examining whether particular transactions were concluded in fulfillment of the principal entity's instructions.[311] This can be appropriate if the principal entity makes *all* significant decisions on behalf of the subsidiary.

3. The third element, which is required only in some instances, is fault on the part of the principal entity. Under Civil Code art. 105(2) and JSC Law art. 6(3), the principal entity bears secondary liability for losses suffered by the subsidiary due to transactions concluded by the subsidiary company in fulfillment of the mandatory instructions of the principal entity. Under Civil Code art. 401(3), the principal entity, as an entrepreneur, will be liable without consideration of fault, although it can avoid liability by showing force majeure, i.e., extraordinary circumstances unavoidable under the given conditions. In contrast, the liability of the principal entity for the debts of the subsidiary company in cases of the latter's insolvency requires fault on the part of the principal entity (Civil Code art. 401).[312]

Under the JSC Law, fault on the part of the principal entity is present only when the principal entity was "fully aware" that its actions or instructions to the subsidiary company would lead to the latter's bankruptcy. This can be extremely difficult to prove in practice.

In the instances in which shareholders of the subsidiary company have the right to demand compensation by the principal entity for losses incurred by the subsidiary company, the question arises as to whether these claims are direct or derivative. Some scholars see these claims as derivative, because the shareholders are protecting their rights indirectly by protecting the rights of the subsidiary company. Other scholars consider that the subsidiary company can also bring these claims itself, to protect its own rights.

Reform proposals

The practical difficulties in finding liability on the part of a principal entity have led to proposals for amendments to the JSC Law as follows:

- establishing a presumption of liability of the principal joint-stock company for the debts of the subsidiary company, whether or not the right of the principal entity to

311 Decision of the Federal Arbitrazh Court of the Ural District, No. F09-2314/02-GK (Sept. 24, 2002) (Постановление Федерального Арбитражного Суда Уральского Округа от 24.09.2002 г., № Ф09-2314/02-ГК).

312 See Decision of the Plenum of the Supreme Arbitrazh Court of the Russian Federation No. 19 "On Some Questions of the Application of the Joint Stock Company Law" point 28 (Nov. 18, 2003) (Постановление Пленума Высшего Арбитражного Суда Российской Федерации от 18.11.2003 № 19 «О некоторых вопросах применения ФЗ «Об АО», пункт 28), and Decision of the Plenum of the Supreme Court of the Russian Federation and the Plenum of the Supreme Arbitrazh Court of the Russian Federation No. 4/8 "On Some Issues of Application of the Federal Law 'On Joint-Stock Companies" point 12 (April 2, 1997) (Постановление Пленума Верховного Суда Российской Федерации и Пленума Высшего Арбитражного Суда Российской Федерации от 02.04.1997 г. № 4/8 «О некоторых вопросах применения Федерального закона «Об акционерных обществах», пункт 12).

give mandatory instructions to the subsidiary company has been formalized in the charter of or a contract with the subsidiary company;

- excluding from the JSC Law the requirement that the principal entity be fully aware that its actions would cause losses to the subsidiary company, or its bankruptcy.

Canada

Assuming that directors or officers of a parent company are not serving on the board of a subsidiary company, they will not owe any duties to the subsidiary or the subsidiary's creditors or shareholders. Instead, they will owe duties to the parent company only and, in exceptional circumstances, to shareholders or creditors of the parent. These duties are discussed in chapter 1 above.

If a parent company makes decisions that have an adverse impact on the shareholders and bondholders of a subsidiary company, the shareholders and bondholders of the parent company will have standing to seek relief under the oppression remedy (CBCA § 238, which defines who can be a "complainant" for purposes of CBCA § 241). If such proceedings were brought and were successful, a court might grant a remedy against the parent company, but would be highly unlikely to impose any sort of liability on the directors or officers of the parent company.

The situation would be different if directors or officers of the parent company were also directors or officers of the subsidiary company, and took actions on behalf of the subsidiary that benefited the parent at the expense of the subsidiary. This would be a straightforward violation of the duty of loyalty. But the liability would be imposed on the directors or officers of the subsidiary, based on their positions with the *subsidiary*, not on their positions with the *parent*.

A parent company, in general, is not liable for its actions with respect to a subsidiary company. There will be instances where a court will "lift the corporate veil" and impose liability on a parent company, but the law on this issue is beyond the scope of this report.

France

French law lacks provisions comparable to the German rules on groups of companies, described below. Although French law contains provisions defining subsidiaries, investment interests and controlled companies (Code de Commerce, arts. L-233-1 et seq.), the members of a group are considered to remain distinct legal entities. In general, one member is not responsible for the debts of another member.[313] Similarly, the managers of a parent company do not have any special obligation toward a subsidiary or its shareholders or creditors.

313 Cass. com. 18 juin 1991, BRDA 30 sept- 1991, p. 14 (finding that a parent firm is not liable for the subsidiary's obligations outside special circumstances); *see generally* M. COZIAN, A. VIANDIER & F. DEBOISSY, DROIT DES SOCIÉTÉS ¶ 1352 (2004).

There are certain circumstances under which parent companies may become liable. Liability may arise in certain instances in which the subsidiary goes into bankruptcy, for example in cases where the assets of the parent and the subsidiary firm are indistinguishable.[314] Moreover, a parent company may itself be liable as a director, either as a dirigeant de droit, who was actually appointed as one, or as a dirigeant de fait, i.e. a de facto director who was not legally appointed, but in practice took over the management of the subsidiary.[315]

That said, the Code de Commerce does not provide any specific duties of directors in this situation (either of the parent firm or of the subsidiary). On the customary duties of directors, see Chapter 1 above. However, concerning the criminal delict of abus de biens sociaux (discussed below in Chapter 13), the courts have developed a remarkable exception that is important for intra-group transactions: Normally a director may be subject to criminal penalties when entering transactions contrary to the interest of the company (intérêt sociale). However, under the Rozenblum decision,[316] he will not be held responsible if the conduct in question was justified by the interest of the group of companies as a whole (intérêt de groupe), in the situation where a group of companies has been established, a coherent group policy was followed, and the individual firm has not become insolvent.[317] Thus, under certain circumstances the interests of the group of companies as a whole may trump the interests of an individual firm and its minority shareholders.

Germany

Generally, AktG § 76 I puts the responsibility of managing the company on the management board. Instructions by shareholders, including a controlling shareholder, are not binding.[318] However, Germany also has special rules for groups of companies.[319] AktG § 291 permits corporations to enter into a "control convention" (Beherrschungsvertrag) with another firm, which requires the fulfillment of certain reporting and auditing requirements, approval by a supermajority vote of 75% of the

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314 *See* M. COZIAN, A. VIANDIER & F. DEBOISSY, DROIT DES SOCIETES ¶ 1357 (2004).

315 Cass. com. 6 juin 2000: RJDA 2000, no 868; M. COZIAN, A. VIANDIER & F. DEBOISSY, DROIT DES SOCIETES ¶ 1358 (2004); Yves Guyon, *Administration. – Responsabilité civile des admiistrateurs,* in JURIS CLASSEUR SOCIETES TRAITE, Fasc. 132-10 (19 Octobre 2005), no. 21.

316 Cass. crim. 4 févr. 1985, Rev. soc. 1985, 648; *see* PHILIPPE MERLE, DROIT COMMERCIAL, SOCIETES COMMERCIALES ¶ 671 (9th edition, 2003).

317 A detailed description of the doctrine in English is provided by Forum Europaeum Corporate Group Law, *Corporate Group Law for Europe,* 1 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW165 (2000), at 198-201.

318 *See for example* UWE HÜFFER, AKTIENGESETZ § 76, ¶ 10 (7th edition, 2006).

319 Germany, Portugal, Hungary, Slovenia, Latvia and the Czech Republic have rules on groups of companies. An English translation of the Latvian Group of Companies Law is at http://www.ttc.lv/New/lv/tulkojumi/E0100.doc. Other European countries are generally similar to Russia in not having extensive rules governing groups of companies.

shares of the firm entering into the control convention, and allows the shareholders of the controlled firm to request that the controlling firm purchases their shares.

One consequence of the existence of a group is the potential for compensatory payments by a parent company to minority shareholders of the controlled company under AktG § 304. Another consequence is the potential for the parent company to give instructions to a controlled firm, which the board of the controlled company is required to follow (AktG § 308 II).

If a group is created, and a parent firm issues instructions to a controlled firm, the board members of the parent firm have the same responsibilities, in issuing instructions to the controlled firm, that they would have for decisions at their own firm (AktG § 309). If the board members of the parent firm violate these duties, they may become liable to the controlled firm (AktG § 309 II).

If a group is created, AktG § 309 IV provides that each shareholder of the controlled firm can bring a derivative suit against the directors of the controlling firm to hold them liable for damages owed to the controlled corporation. However, shareholders of the controlled firm can only require payments to be made to controlled firm, not to themselves. Creditors of the controlled company can also bring such a suit, and can seek payments to be made to them directly.[320] A waiver or settlement of such a claim by the controlled company is not binding on creditors. If the controlled company is insolvent, the insolvency administrator can bring such a claim on behalf of the creditors.

At the same time, the controlling entity is not *per se* liable to creditors of the controlled firm. There must be proof of a violation of duty, with respect to the controlled company. Some case law indicates that misconduct by board members of the controlling firm in the capacity as managers of the controlling firm, will not be imputed to a controlled firm, when they are also board members of the controlled firm.[321]

In the absence of an explicit agreement on a control convention -- that is, in a "de facto group"), a controlling firm may not use its influence to cause the controlled firm to enter into disadvantageous contracts, unless the disadvantage is compensated by the end of the same business year (AktG § 311).[322] If there is no compensation by the end of the year, the controlling firm is liable to the controlled firm for damages, and can be liable to the shareholders of the controlled firm for any damage that is not also damage to the controlled company (AktG § 317 I). There is no liability if a conscientious manager of an independent company would had entered into the contract as well (AktG § 317 II). The legal representatives of the controlling firm (generally, members of its management board) who initiate the measure are jointly and severally liable, together with the controlling firm (AktG § 317 III). The procedures provided in AktG § 309 for derivative

320 UWE HÜFFER, AKTIENGESETZ § 309, ¶ 23 (7th edition, 2006).

321 BGHZ 90, 381, 396.

322 The term "controlling company" is defined in AktG § 17: Ownership of more than 50 % of the shares is usually sufficient. Less than 50% can be sufficient depending on the usual participation at the general meeting (see UWE HÜFFER, AKTIENGESETZ § 17, ¶ 9 (7th edition, 2006), for court decisions which even accepted 20 % in some cases).

suits, brought by shareholders or creditors of the controlled company, apply in this situation as well (AktG § 317 IV).

In addition to the special rules for corporate groups described above, the general provisions on veil piercing developed by the courts and the legal literature are potentially relevant as well, in particular when the subsidiary has been undercapitalized or there has been commingling of funds or operations.[323] In some recent cases, the Federal Supreme Court has developed the doctrine of "interference resulting in the destruction of the subsidiary's existence" (existenzvernichtender Eingriff), which is invoked when a direct or indirect sole shareholder uses his position to extract some of the subsidiary's property, resulting in insolvency.[324] In a veil piercing case resulting in a claim against the parent company, a damages claim against its directors may result if the actions resulting in the claim can be considered a violation of the director's duty of care, but the relevant duty will be owed to the parent, not to the subsidiary.

Another doctrine related to veil piercing is the de facto manager (faktischer Geschäftsführer). This concept is typically applied to limited liability companies (GmbHs), but should also apply, in principle, to joint stock companies. The term refers to a person who acts as the manager of the firm without having been appointed to the position. Typically, this will be a shareholder of the company. This person will then be subject to the same liability rules as the firm's legally appointed manager.[325] Since a legal person cannot be the manager of a firm,[326] the parent company cannot be liable under this doctrine.[327] However, if a director of a parent company acts as the de facto manager of the subsidiary, this person can become liable.

These additional doctrines concerning veil piercing and so on have not been implemented by statute, and arise only under the case law.

Korea

The KCC has the rules with regard to the liability of *de facto* or shadow directors, who act as if they were directors, but without having a formal position. A director of the parent company who in fact makes important business decisions for a subsidiary company could be regarded as a *de facto* director of the controlled company. If so, he would have the same fiduciary duties as normal directors, and could be liable for damages for breach of this duty, which is owed to the controlled company. The relevant provision on de facto directors is KCC art. 401-2:

> Article 401-2 (Liability of Person who Instructs Another Person to Conduct Business)

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323 UWE HÜFFER, AKTIENGESETZ § 1, ¶ 19-20 (7th edition, 2006).

324 BGHZ 151, 181; NJW 2005, 177.

325 *See, for example,* Ulrich Haas, in GMBH-KOMMENTAR § 43, ¶ 25 et seq. (Lutz Michalski, editor, 2002).

326 *Id.*

327 BGHZ 150, 61.

(1) A person who falls under any of the following subparagraphs shall be deemed to be a director . . . [for] the duties which he instructs or conducts:

1.A person who instructs a director to conduct business by using his influence over the company;

2.A person who conducts business in person under the name of a director; and

3.A person other than a director who conducts the business of the company by using a title which may be recognized as authorized to conduct the business of the company, such as honorary chairman, chairman, president, vice-president, executive director, managing director, director, or others.

(2) . . . [A] director who is liable for damages to a company or third party shall be jointly and severally liable therefore with a [de facto director determined in accordance with] paragraph (1).

However, the *de facto* director liability provisions are rarely used, because it is difficult to prove that some has acted as a *de facto* director.

United Kingdom

Assuming that directors or officers of a parent company are not serving on the board of a subsidiary company, they will not owe any duties to the subsidiary or the subsidiary's creditors or shareholders. Instead, they will owe duties to the parent company only and, in exceptional circumstances, to shareholders or creditors of the parent.

If directors of a parent company who have not been appointed as directors of a subsidiary nevertheless involve themselves directly in the day-to-day running of the subsidiary as managers, it is possible those directors could be deemed under § 741 of the Companies Act 1985 (replaced by Companies Act 2006, § 251) to constitute directors or "shadow directors" of the subsidiary. This would mean that with respect to the subsidiary they could be sanctioned for failing to fulfill the usual fiduciary duties and other obligations of directors under the Companies Act.

A parent company, in general, is not liable for its actions with respect to a subsidiary company.

United States

In general, if directors or officers of a parent company do not serve in a similar capacity on the board of a subsidiary company, they do not owe any duties to the subsidiary or the subsidiary's creditors or shareholders. Instead, they owe duties to the parent company only. These duties are discussed in chapter 1 above.

The situation would be different if directors or officers of the parent company were also directors or officers of the subsidiary company, and took actions on behalf of the subsidiary that benefited the parent at the expense of the subsidiary. Persons who take on dual roles have a full fiduciary duty to both companies.[328] As a practical matter, this puts these persons in a difficult position, and they would be well advised to abstain from a decision by the subsidiary which might conflict with the interests of the parent.

If persons have a dual role, and act to benefit the parent, this would violate their duty of loyalty to the subsidiary. But the liability would be imposed on the directors or officers of the subsidiary, based on their positions with the *subsidiary*, not on their positions with the *parent*.

A parent company, in general, is not liable for its actions with respect to a subsidiary company. There are exceptions, where the subsidiary is considered to be under the domination and control of the parent, where courts may "pierce the corporate veil" and hold the parent liable for the obligations of the subsidiary, when the subsidiary has become insolvent and cannot pay its own debts.

There is also an important exception for transactions between a subsidiary and a parent company, especially a freezeout of the minority shareholders of the subsidiary. In these transactions, the parent is considered to owe a fiduciary duty to the minority shareholders of the subsidiary, which requires it to treat them fairly.[329]

Summary and recommendations

The JSC Law provides for a parent company to be liable for the obligations of its subsidiaries only in limited circumstances. One of these circumstances is when the charter of the subsidiary gives the parent company the right to issue instructions to the subsidiary which are binding on the subsidiary. JSC Law art. 6(3)(2-4) provides:

> A principal entity (partnership) which has the right to give mandatory instructions to a subsidiary company is jointly and severally liable with the subsidiary for transactions made by the subsidiary in fulfilling such instructions. A principal entity (partnership) is considered to have the right to give mandatory instructions to its subsidiary company only if this right is provided for under a contract with the subsidiary company or under the charter of the subsidiary company.
>
> In the case of insolvency (bankruptcy) of a subsidiary company through the fault of its principal entity (partnership), the latter shall bear subsidiary liability for the subsidiary's debts. Insolvency (bankruptcy) of a subsidiary company is considered to have occurred through the fault of the principal entity (partnership) only if the principal entity (partnership) has used the specified right to give mandatory instructions and (or) specified possibility (to determine the subsidiary's decisions) in order to have the subsidiary perform an action while fully aware that the subsidiary company's insolvency (bankruptcy) would result from such action.
>
> Shareholders of a subsidiary company have the right to demand compensation from the principal entity (partnership) for losses caused through its fault to the subsidiary company. Losses are considered to have been caused through the fault

328 Sinclair Oil Company v. Levien, 280 A.2nd 717 (Delaware Supreme Court, 1971).

329 Weinberger V. UOP, Inc., 457 A.2nd 701 (Delaware Supreme Court, 1983).

of the principal entity (partnership) only if the principal entity (partnership) used its right to give mandatory instructions and (or) its opportunity (to determine the subsidiary's decisions) to have the subsidiary perform an action while fully aware that the subsidiary company would incur losses as a result of such action.

These provisions are similar to the German rules on groups of companies, in that they apply only if the companies have formally agreed to be part of a commonly controlled group. However, a German parent company can potentially be liable for controlling a subsidiary's actions without formally entering .into a control convention. Russian law has no comparable provisions.

These provisions have been criticized by Russian commentators, on the basis that in many cases, the parent has the practical right to give instructions to the subsidiary, but will be protected against liability as long as this right is not included in the subsidiary's charter. It has been suggested that the question of whether the parent can give instructions to the subsidiary should be a question of fact, not simply a matter of whether this right is included in the subsidiary's charter. Germany's rules for limited liability companies have faced similar criticism, which have led the German courts to apply the concept of a de facto group with regard to limited liability companies.

Before offering our own recommendations, it is worth specifying the nature of the concern. As a practical matter, it is common for a parent to have effective control over a subsidiary. In most cases, this control is carried out through decisions made on behalf of the subsidiary by the managers and directors of the subsidiaries, who may also have positions in the parent company. We need to consider separately the case of a wholly owned subsidiary, and the case of a partly owned subsidiary.

Wholly owned subsidiaries

For a wholly owned subsidiary, there is no concern with the interests of shareholders of the subsidiary company. There is potential for creditors of the subsidiary company to be harmed by actions which remove assets from the subsidiary. However, in most cases, the protections provided by the contract between the creditor and the subsidiary, supplemented by bankruptcy law, should be sufficient to address creditors' concerns.

In particular, a creditor can agree to provide credit only if there is a guarantee from the parent company, or restrictions on the ability of the parent company to remove assets from the subsidiary. There remains the possibility that the parent company may violate these restrictions. In this case, it is appropriate to hold the parent company liable for harm to the subsidiary which leads to harm to the creditors of the subsidiary. Bankruptcy law provides for this in part, through preference and fraudulent conveyance rules, which could require reversal of transactions which benefit the parent, or potentially third parties, at the expense of the subsidiary (see the discussion of insolvency in Chapter 6).

Bankruptcy Law is beyond the scope of this Report. We have not examined the rules under the current Bankruptcy Law to assess whether they provide sufficient protection for the interests of creditors of a wholly owned subsidiary. However, we believe that the Bankruptcy Law is the appropriate location for these rules.

Partially owned subsidiaries

Partially owned subsidiaries raise the same potential for actions by the parent company to harm the creditors of the subsidiary, as do wholly owned subsidiaries. Here too, the Bankruptcy Law is the appropriate location for rules to protect creditors of the subsidiary.

Partially owned subsidiaries raise a separate concern with harm to the shareholders of the subsidiary, due to actions, taken at the direction of the parent company, that benefit either the parent company or its managers and directors, at the expense of the shareholders of the subsidiary.

At one level, these concerns can be seen as no different than the usual concerns about conflict of interest transactions between a company and a controlling shareholder, where the controlling shareholder happens to be another company, instead of an individual. There is no particular reason for concern about actions that do not involve a conflict of interest. For actions that do involve a conflict of interest, there is reason for concern. There are two distinct ways to address this concern. One is through rules that impose duties on controlling shareholders, for conflict of interest transactions. We propose such rules in Chapter 1.

Possibility to consider parent company to be a managing organization

A second possibility is to adopt rules that address specifically the relationship between a parent company and a partially owned subsidiary company. Suppose, for example, that it could be proven, as a factual matter, that a subsidiary company was in fact managed by a parent company, in a manner similar to the relationship that might exist between a company and a managing organization. This management authority could be shown to exist either in general, or for a specific transaction that is challenged by minority shareholders of the subsidiary company.

It would then be possible to treat the parent company as if it were a managing organization. The parent company would face the same duties as a managing organization would face. Its directors and managers, who were active in managing the business of the subsidiary, would face the same duties and subsidiary liability as the directors and managers of a managing organization. The only difference would be that the existence of a management relationship between parent and subsidiary would have to be proven, since there would be no formal contract between the parent and the subsidiary providing management powers to the parent.

We recommend treating a parent company which, in practice, adopts decisions on behalf of a subsidiary or dependent company, as if it were a managing organization. This approach has no close parallel in the laws of the comparison countries. Instead, it builds on the special Russian concept of a managing organization, which also does not exist in most of the comparison countries. Given that Russian law must already address the issues raised when a company has a managing organization, and given the strong similarity between official management by a managing organization and de facto management by a parent company, we consider this approach to be sound.

Chapter 8. Judicial proceedings in connection with liability of directors and managers

Subchapter 8.1 Procedural points of liability of directors and managers

Issue: What procedures are appropriate for bringing a suit against company managers and directors?

Russian context

Who can file a claim

Under JSC Law art. 71(5), a suit can be brought against a member of the company's board of directors, the company's single-person executive organ, a member of the company's collegial executive organ, the manager or the managing organization, either by the company itself or by shareholders holding at least 1% of the company's common shares. A claim by a non-empowered person can be dismissed under Arbitrazh Procedure Code art. 150(1).

A claim by the company is a direct claim to protect the company's own interests. The question remains open as to who has the right to file a claim in the name of the company. Under general rule of representation, the company's single-person executive organ has this right. It is unclear whether other management organs, such as the board of directors, also have this right. One solution would be for the company's charter to address this issue.

A claim filed by shareholders is a derivative claim, brought on behalf of the company. Judicial practice examined shows that most claims are made by shareholders to protect the interests of the company. Claims against a company's executive bodies are made rather frequently.[330] As the details of derivative actions have not been specified in the law, they are the subject of considerable discussion. Some scholars view the derivative action as a means of protecting the rights of two persons -- the company and the shareholder. Most scholars believe that only shareholders have the right to file a derivative action. In particular creditors do not have this right. Judicial precedent supports this opinion.[331]

Jurisdiction: regular courts or arbitrazh courts?

330 See, for example, Decision of the Federal Arbitrazh Court of the Central District, No. A08-5583/03-4 (Feb. 13, 2004) (Постановление Федерального Арбитражного Суда Центрального Округа от 13 февраля 2004 г. N А08-5583/03-4); Decision of the Federal Arbitrazh Court of the Ural District No. F09-703/06-S5 (Feb. 16, 2006) (Постановление Федерального Арбитражного Суда Уральского Округа от 16 февраля 2006 г., N Ф09-703/06-С5); Determination of the Supreme Court of the Russian Federation No. 14-V01-31 (May 30, 2002) (Определение Верховного Суда Российской Федерации от 30 мая 2002 года, N 14-В01-31).

331 Decision of the Plenum of the Supreme Arbitrazh Court of the Russian Federation No. 19 «On Some Questions of the Application of the Joint Stock Company Law» (Nov. 18, 2003) (Постановление Пленума Высшего Арбитражного Суда Российской Федерации от 18.11.2003 № 19 «О некоторых вопросах применения ФЗ «Об акционерных обществах»).

A difficult question, on which the Supreme Arbitrazh Court and the Supreme Court have different views, involves the circumstances under which a shareholder can bring a claim against a company or its management organs in the regular courts, as opposed to the arbitrazh courts. Under Arbitrazh Procedure Code art. 33(1.4), disputes between a shareholder (whether a legal entity or a physical person) and a joint-stock company that stem from the company's activities -- except for labor disputes -- are within the jurisdiction of the arbitrazh courts. The Supreme Arbitrazh Court has stated that not all disputes between a company and its shareholders are within the jurisdiction of the arbitrazh courts, but, rather, only those which are connected with the exercise of shareholders' and a company's rights and the fulfillment of their obligations, including suits by shareholders seeking recovery of losses from members of a company's management organs.[332] If this view is accepted, then disputes between shareholders and members of a company's management organs are within the exclusive jurisdiction of the arbitrazh courts. However, as a result of legislative imprecision, lower courts of general jurisdiction do not always adopt this view. As a result, appellate courts sometimes have to rectify instances of improper acceptance of jurisdiction by lower courts.[333]

A potentially separate issue of jurisdiction involves claims by members of a company's management organs, brought against the company after these persons have been dismissed from their positions. The executive often claims that he is entitled under labor legislation to damages or to retain his position. The Supreme Court has stated that "relations between companies' single-person executive bodies (general directors) and/or members of companies' collegial management organs on the one hand and the companies on the other *are based on labor contracts*" and therefore should be heard by the regular courts.[334]

This view can also support the broader proposition that the overall relationship between a member of a company's management organs and the company is based principally on

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332 Decision of the Plenum of the Supreme Arbitrazh Court of the Russian Federation No. 11 «On Some Questions Connected with the Implementation of the Arbitrazh Procedural Code of the Russian Federation» point 6 (Dec. 9, 2002) (Постановление Пленума Высшего Арбитражного Суда Российской Федерации от 09.12.2002 № 11 «О некоторых вопросах, связанных с введением в действие Арбитражного процессуального кодекса Российской Федерации», пункт 6).

333 See, for example, Decision of the Federal Arbitrazh Court of the Ural District No. F09-1180/03-GK (May 7, 2003) (Постановление Федерального Арбитражного Суда Уральского Округа от 7 мая 2003 года, N Ф09-1180/03-ГК); Decision of the Federal Arbitrazh Court of the Central District No. A09-7324/04-10 (June 13, 2006) (Постановление Федерального Арбитражного Суда Центрального Округа от 13 июня 2006 г., N А09-7324/04-10).

334 Decision of the Plenum of the Supreme Court of the Russian Federation No. 2 «On Some Issues Arising in Connection with the Acceptance and Implementation of the Civil Procedure Code of the Russian Federation» point 6 (Jan. 20, 2003) (Постановление Пленума Верховного Суда Российской Федерации от 20 января 2003 г. № 2 «О некоторых вопросах, возникших в связи с принятием и введением в действие Гражданского процессуального кодекса Российской Федерации», пункт 6); Decision of the Plenum of the Supreme Court of the Russian Federation No. 17 "On Some Problems Arising in Legal Practice during the Examination of Cases on Labor Disputes with Joint-Stock Companies, Other Economic Partnerships, and Companies» (Nov. 20, 2003) (Постановление Пленума Верховного Суда Российской Федерации от 20 ноября 2003 г. № 17 «О некоторых вопросах, возникших в судебной практике при рассмотрении дел по трудовым спорам с участием акционерных обществ, иных хозяйственных товариществ и обществ»).

labor relations, so that a suit by the company or by shareholders against these members is governed by labor legislation and is properly heard by the regular courts, rather than the arbitrazh courts. For example, in 2003 the Supreme Court provided a detailed explanation of why, in its opinion, a dispute between a joint-stock company and the general director of that company over the recovery of damages for losses incurred by the company through the actions of the general director arises from labor relations and is therefore subject to the jurisdiction of federal courts.[335]

The disagreement between the Supreme Arbitrazh Court and the Supreme Court over the jurisdiction of the regular courts will need to be resolved, either by the legislature or by a joint decision of the two courts.

Procedural issues in derivative suits

A number of procedural issues raised by shareholder derivative suits have not been resolved by the legislature or by judicial practice. Ttwo related questions involve expenses:

- is the shareholder entitled to compensation for legal expenses if the suit is successful?
- is the shareholder responsible for the legal expenses of the defendants if the suit is not successful?

Under Arbitrazh Procedure Code art. 101 and Civil Procedure Code art. 88, legal expenses comprise state fees and court costs associated with the hearing. In general, legal expenses borne by the party in whose favor the court decision is made are recovered by the court from the opposing party. If a claim is partly sustained, legal expenses are paid by both parties in proportion to the degree that their demands were sustained (Arbitrazh Procedure Code arts. 110-111, Civil Procedure Code art. 98). The question of whether legal expenses are paid to (or by) the shareholder or the company depends directly on whether the shareholder or the company is deemed to have the status of a party -- a plaintiff -- in the case.

A derivative action is filed by a shareholder first and foremost not to protect his own interests but, rather, those of the company. Some scholars are therefore of the opinion that the company should be the plaintiff and that the filing of a claim by a shareholder on behalf of a company can be viewed as a form of representation. Current judicial practice adheres to this opinion.[336] In the opinion of other experts, however, the shareholder is seeking to protect his own rights as well as the rights of the company, and thus should be considered to be a plaintiff. Some of these scholars believe that the company should be brought into the hearing as a co-plaintiff. Another opinion is that the most appropriate

335 Review of the legislation and judicial practice of the Supreme Court of the Russian Federation for the third quarter of 2003, approved by the decision of the Presidium of the Supreme Court of the Russian Federation (Dec. 3 and 24, 2003) (Обзор законодательства и судебной практики Верховного Суда Российской Федерации за третий квартал 2003 года, утвержденный постановлением Президиума Верховного Суда Российской Федерации от 3 и 24 декабря 2003 г).

336 Decision of the Federal Arbitrazh Court of the Moscow District No. KG-A40/1768-06-P (Mar. 16, 2006 and 14 Mar. 14, 2006) (Постановление Федерального Арбитражного Суда Московского Округа от 16.03.2006, 14.03.2006, № КГ-А40/1768-06-П).

status for the company is that of a third party not making any independent demands with respect to the dispute.

The company's status, whether as a plaintiff, co-plaintiff, or third party, affects its rights in the proceeding, as well as its right to be compensated for legal expenses or obligation to pay legal expenses. If the company is considered to be merely a third party, then under the Arbitrazh Procedure Code, it will not have the right to seek to change the basis or the subject of the claim, the amount of claimed damages, to renounce the claim, etc. Only the shareholder would then have these rights.

The unusual nature of a derivative action also requires codification of a procedure for fulfillment of a judicial decision awarding damages. Under Law on Enforcement Proceedings art. 29, the person who has the right to enforce a judicial decision is "the citizens or the organization in whose favor or interests the [decision] is made." For a derivative action, this would be the company itself. This means that the company, which may still be controlled or influenced by the persons who are required to pay damages, is responsible for enforcing the judgment against these same persons. This allows these persons to influence the fulfillment of the judicial decision, which is an unacceptable result. Thus, in our opinion, Law on Enforcement Proceedings art. 29 should be amended to provide that a shareholder has the right to enforce a favorable judicial decision in a derivative suit.

Class action suits

In arbitrazh court hearings, a class-action suit is not currently possible. Many scholars believe that Russia needs to develop the concept of class-action suits, which allow for combining the demands of a group of citizens and organizations into a single hearing, and will allow minority shareholders greater access to due process. The class action procedure can also be used to resolve problems of multiple shareholder claims and competing judicial decisions arising from the same facts.[337]

Draft amendments to the Arbitrazh Procedure Code and related legislation, aimed at improving the procedures for resolving disputes involving companies, would amend the Arbitrazh Procedure Code, to specify the types of corporate disputes which fall under the exclusive jurisdiction of the arbitrazh court,[338] The amendments include one article on class-action (group) suits, but this article has technical problems, and conflicts with Arbitrazh Procedure Code chapter 6 and art. 44. The draft also establishes liability for abuse of the right to file a class-action claim to protect the rights of other persons in the form of compensation of losses caused by an unfounded claim or a judicial fine.

337 Y. V. Romanova, *Protection of the Rights of Minority Shareholders in the Russian and Foreign Civil Law*, THE LAWYER, No 8 (2004) at 38-46 (Ю.В. Романова *Защита прав миноритарных акционеров по российскому и зарубежному гражданскому прав,* ЮРИСТ).

338 See, for example, G. O. Abolonin, *New Claims*, ECONOMICS AND LIFE: THE JURIST, No 11 (2006) (Г. Аболонин *Новые иски*, ЭЖ-ЮРИСТ).

Canada

Under Canadian law, directors generally owe duties to the company and only to the company. Thus, in most cases, a suit claiming breach of fiduciary duty by directors must be brought by the company. This creates the well-known problem that directors are unlikely to cause the company to sue a member of their own board. Canadian corporate legislation provides that a judge can, under specified conditions (e.g., the complainant is acting in good faith and it is in the company's interests that the suit go ahead) grant a minority shareholder leave to sue on a company's behalf (e.g. CBCA § 239, OBCA § 246). Use of this derivative action procedure has been limited, however, particularly when self-serving conduct has been lacking and a public company has been involved.[339]

Various factors deter the launching of derivative suits under the statutory procedure. A shareholder must first apply to the court for leave to bring a suit. This petition will, predictably, be opposed by the directors and by the company. A shareholder who applies for leave to sue, and does not receive this leave from the court, will likely face a court order to pay the court costs and legal fees incurred by the defendants, since Canadian courts apply the "English rule" and generally require the losing side in a court proceeding to pay at least some of the successful party's legal costs.

If a shareholder obtains leave, the shareholder must still be prepared to finance the trial since Canadian courts have been reluctant to order companies to pay legal expenses until final disposition of derivative litigation. Moreover, if a derivative suit fails at trial, the court may well invoke "loser pays" principles to order the shareholder plaintiff to reimburse the defendants' legal expenses.

An additional factor that deters derivative litigation is that in a successful suit any recovery will be paid to the company rather than to the shareholder. The situation is different with the oppression remedy, where if a suit is successful a judge will typically grant a remedy that benefits the complainant directly (most commonly a buy-out of his shares). Given this, and given that misconduct constituting a breach of duty by directors can qualify as being "oppressive" or "unfairly prejudicial" to shareholders, minority shareholders typically prefer to sue under the oppression remedy rather than launch derivative litigation, when both types of actions are possible.[340]

In the United States, most derivative suits are settled. As discussed below, the settlement agreement will typically recite that the suit has conferred a "substantial benefit" on the corporation, and the corporation will agree to pay the plaintiffs' attorneys' fees. Judges must approve settlements, but they rarely object to the parties' agreement on fees. This provides lawyers with an incentive to pursue derivative litigation when plaintiff shareholders would not otherwise bother because the recovery will go to the corporation.

The situation is different in Canada, because Canadian corporate law does not authorize settlements structured to provide for payments directly from the company, which is nominally the plaintiff, to the lawyers engaged by the shareholders. Both the CBCA and

339 See Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEXAS LAW REVIEW 1385-1480 (2006), at 1443-1444.

340 See DENNIS H. PETERSON, SHAREHOLDER REMEDIES IN CANADA §§ 18.101.1, 18.235–18.237 (looseleaf publication, 1989).

the OBCA empower a court to make an order requiring the corporation to pay the legal fees incurred by a complainant in a derivative suit (CBCA § 240(d), OBCA § 247(d)). The parties likely cannot privately agree to a settlement with the company paying the legal fees of the complainant, because court approval is required to discontinue a derivative suit (CBCA § 242(2), OBCA § 249(2)), and the Canadian courts would be unlikely to approve a settlement in which the company agrees to pay legal fees unless the court had previously made a specific order approving this payment.

France

Generally, suits for damages are brought by the legal representatives of the company under French law. Individual shareholders may sue when they have sustained a disadvantage that is not identical to the one sustained by the company.[341] Moreover, French law has since the mid 1800s allowed a derivative suit, brought by shareholders in the name of the company. The main provisions governing these suits are:

> ***Article L. 225-252***: Apart from actions for personal loss or damage, shareholders may either individually or in an association fulfilling the conditions laid down in Article L.225-120, or acting as a group in accordance with conditions to be laid down by an Order approved by the Conseil d'Etat,[342] bring an action for liability on behalf of the company against its directors or CEO. The plaintiffs shall be authorised to sue for compensation for the full amount of the loss or damage suffered by the company . . . .
>
> ***Article L. 225-253***: Any clause in the memorandum and articles of association the effect of which would be to make the exercise of any action subject to prior notice or to the consent of the general meeting, or to waive the right to any such action in advance, shall be deemed non-existent. No decision of the general [shareholder] meeting shall have the effect of extinguishing an action for liability against the directors or CEO for a tortious or negligent act committed in the performance of their duties.
>
> ***Article L. 225-254:*** Any action for liability against the directors or CEO, either by an individual or individuals or by the company, must be brought within three years of the act or event causing the loss or damage, or, if the same was concealed, the discovery thereof. Nevertheless, where the act is defined as a criminal offence, the said period shall be extended to ten years.

For a firm with a one-tier board of directors, these rules apply to suits against the directors and to the CEO (Code de Commerce, art. L. 225-252). For a firm with a two-tier board of directors, they apply to suits against members of either the supervisory board or the management board (Code de Commerce, art. L. 225-256, 225-257).

341 TERRÉ ET AL., LE DIREGEANT DE SOCIÉTÉ: RISQUES AND RESPONSABILITÉS § 061-18 (2002).

342 There are also simplified representation provisions for an action by several shareholders. As a rule, they must hold 5% of the firm's shares. See Décret no 67-236 sur les sociétés commerciales (as amended), article 200) and shareholder associations (Loi no 94-679 du 8 août 1994).

The rules on derivative suits do not apply to the assistant general managers, which is consistent with the rule that the duties owed by directors to the company do not apply to assistant general managers (see chapter 1). These persons are potentially liable to the company for breach of their employment or service contract. Such a suit must be brought directly by the company.

Shareholders may either sue individually, or as an association. For a suit by an individual shareholder, there is no minimum percentage of shares which the shareholder must hold. Standing does not depend on the shareholder's ownership level. However, associations of shareholders are required to represent 5% of voting rights (art. Code de Commerce art. L. 225-120). This percentage is lower for larger firms, measured by their charter capital. A single representative may be elected (unanimously) by a group of shareholders.[343] The "collective" suit apparently has some cost advantages over suits brought by individual shareholders.[344]

As a practical matter, shareholder suits employing the derivative suit procedure are rare. This is partly because of the difficulty of proof, including the need to show the directors' fault,[345] but also and especially reflects the cost to a shareholder to bring such a suit. Lawyers' costs are especially problematic. In commercial cases, including suits by shareholders, the winner cannot demand them back from the loser. If a derivative case succeeds, the shareholder's reasonable legal fees should be reimbursed by the company, though there is no specific statutory provision on this point. However, a shareholder who loses a suit has no claim for reimbursement by the defendants or the company. He is left burdened with his own lawyers' fees. Yet, even if the suit is successful, the recovery is paid to the company.

This asymmetric risk, of paying fees if you lose, but not recovering damages personally if you win, might be reduced by contingency fees, but these are not permitted in France. A proposal to allow contingency fees was rejected in 1996 in the Marini Report.[346]

Another possibility, which in the past has been used more often than the derivative suit, is to assert a claim for compensation for damages against members of the board through a so-called "action civile" in connection with criminal proceedings.[347] This action has been summarized as follows:[348]

> France . . . allows persons who have been victimized by the commission of a criminal offense to commence an action civile (civil action) against the party who has committed the criminal offense. As the result of an action civile, the victim

343 Décret no 67-236 sur les sociétés commerciales (as amended), article 200.

344 FRANCIS LEFEBVRE, MÉMENTO SOCIÉTÉS COMMERCIALES ¶ 8516 (2006).

345 See, for example, FRANCOIS BASDEVANT, ANNE CHARVERIAT & FRANCOISE MONOD, LE GUIDE DE L'ADMINISTRATEUR DE SOCIETE ANONYME 185 (2nd edition, 2004), at 185.

346 PHILIPPE MARINI, LA MODERNISATION DU DROIT DES SOCIÉTÉS 96 (Rapport au premier ministre, 1996).

347 See PHILIPPE MERLE, DROIT COMMERCIAL, SOCIETES COMMERCIALES § 416 (9th edition, 2003).

348 Christopher D. Van Blarcum, *Internet Hate Speech: The European Framework and the Emerging American Haven*, 62 WASHINGTON AND LEE LAW REVIEW 781 (2005).

can receive damages, restitution, and recovery of legal costs. Although an action civile is generally reserved only for those victims who have "personally suffered the harm directly caused by the offence," France allows associations to commence the action where provided for by law.

Thus, a criminal breach of duty under company law would give rise to the right of the company, directly or through a derivative suit brought by shareholders, to seek damages resulting from the criminal misconduct.

However, the importance of penal provisions in company law was recently reduced. A preventive procedure enabling a temporary order against an action by management was provided for instead.[349] Thus, there will be less opportunity in the future for shareholders to bring a civil action that accompanies a criminal action.

The procedure for forming a shareholder association, in order to bring a derivative suit was also recently simplified.[350] However, it is doubtful whether these reforms will acquire any practical importance. The core problem is the law on costs, since the shareholder association must itself bear the costs of bringing the suit.

Germany and Austria (with a note on other countries)

The German rules governing suits against directors were altered significantly by a reform act in 2005. It is too early to predict what effect these reforms will have on the actual incidence of suits against directors, which have been rare.

Under AktG § 147 I, the shareholder meeting may vote to instruct the company to claim damages against a director. Of course, the company may not do a vigorous job of pursuing a claim that its board did not want to bring, against a member of the board. Therefore, shareholders are also permitted to vote to appoint a special representative to enforce a claim. A court also has discretion to appoint such a representative upon request by a minority representing 10% or €1 million of the firm's stated capital. The court has discretion to refuse this request, depending on whether it considers the appointment of a representative advisable under the particular circumstances. The firm may appeal a decision to appoint a representative (AktG § 147 II).

The newly introduced AktG § 148 I provides a new possibility for derivative suits. Given that this procedure was enacted only fairly recently, it remains to be seen whether it will encourage a larger number of lawsuits than previous law.

AktG § 148 allows a minority representing either 1% or €100,000 (down from 10%) of the firm's stated capital to request permission from a court to enforce a claim to damages owned by the company, but with payment still to be made to the company. Shareholders must meet a fourfold test by showing that:

- they became shareholders before learning (and without negligently remaining ignorant) about the damage incurred by the firm;

349 Code de Commerce 2000, article L. 238-1, changed by Ordonnance no 2004-604 du 24 juin 2004.

350 Loi no 2003-706 du 1er août 2003, article 136 which amends Code monétaire et financier 2000, article L. 452-1; compare Code de Commerce 2000, arts. L. 225-120, 225-252.

- they demanded that the firm itself brings the suit and set it an appropriate deadline, and the company either refused or did not meet the deadline;
- there are grounds for the court to believe that facts can be proved which indicate that the company incurred damage because of dishonesty (*Unredlichkeit*) or serious violations of the law or the charter; and
- enforcement would not be contrary to the company's interest.

These conditions must be met for the court to permit the suit to proceed past a preliminary stage. If the suit proceeds, this fact must be publicized (AktG §149 I). Subsequently, plaintiff shareholders must again request that the company itself to bring the suit and allow it an adequate time to respond. Assuming the company either does not respond or continues to refuse to bring the suit, the actual derivative suit must be brought in the same court, within three months after the decision on its admissibility.

The costs of the request for admission of a suit are generally borne by the plaintiff shareholder if admission is denied. There is some scope for a court to order that costs should be borne by the firm if admission was denied because a suit would be contrary to the company's interest, and the company failed to inform the shareholder of the reasons for this. If the suit is accepted, the court will decide about costs in the final verdict on the derivative suit. If the company decides to bring the suit itself, it must assume the plaintiff shareholder's costs. Otherwise, the company must bear shareholders' costs if the suit is unsuccessful or only partially successful, unless the plaintiff shareholder's case rested on false pleading, which the plaintiff knew to be false or failed to know to be false because he was grossly negligent (AktG § 148 VI). If the suit succeeds, the defendants will pay the shareholders' costs to the company under Germany's usual loser-pays rules, and the company would then reimburse the shareholders.

Austrian law resembles German law before the 2005 reforms: Shareholders holding 10% of a company's stated capital may require that damages claims are brought against members of the supervisory board or management board (or by the company against shareholders), unless their claim is obviously baseless. A minority of 5% will suffice if an auditor's report specifies facts that establish the claim (Austrian Aktiengesetz § 122 I).

Other countries: Hurdles that make it difficult to bring derivative suits can also be found in other European countries. For instance:

- Under **Latvian** Commercial Code § 172, holders of 5% of the equity capital or equity capital of not less than 50,000 lati have the right to sue
- In the **Czech Republic** shareholders of a company whose registered capital is higher than CZK 100 million need 3 % of the outstanding shares to bring a derivative suit, otherwise 5% of the registered capital (Czech Commercial Code, §§ 182(2), 181(1)).
- Under **Italian** law, the holders of 20% of the outstanding shares may bring a derivative suit. This amount is reduced to 5% for public companies. Plaintiff shareholders are required to elect one or more representatives for the suit (Italian Civil Code 2393bis).

Korea

Derivative suits are not popular among investors in Korea. Technically, there is no significant burden or barrier to file a derivative suit. However, not much incentive is available for the shareholders, since the recovery is paid to the company. Therefore, no such suit was filed before 1997. Even after 1997, only shareholder rights activists are filing derivative suits. Thus far, there have been only two true derivative suits in Korea, filed by shareholders as such.

A principal reason is that, as a general rule, if a plaintiff loses the lawsuit, he or she must pay part of defendant's litigation costs, including attorney's fees (Korean Civil Procedure Act art. 98). No contingency fee arrangement is allowed in Korea.

Korea has recently introduced the possibility for class action lawsuits in securities cases. In 2005, some thirty shareholders of a public company considered bringing the first securities law class action in Korea, but they abandoned the idea when they were advised of the risk of having to pay the defendants' legal costs. Large Korean law firms are not interested in representing clients in class action and derivative cases, because their principal clients are the likely defendants. Smaller law firms cannot afford the advancement of the legal costs and cannot afford to accept the financial risk of losing the suit, in which case they will likely not be paid. And shareholders are not willing, thus far, to advance legal expenses, for a suit where the recovery will be paid to the company, nor to take the risk of also paying the defendants' legal expenses if the suit fails.

To address the insufficient incentives to bring derivative suits, Korea is considering amendments to the KCC to provide for a suit to be brought on behalf of multiple shareholders, so that the expenses of the suit can be shared. The proposed amendments will also allow 3% shareholders of a controlling company to investigate the books of a controlled company (a company which is at least 50% owned by the controlling company).

In 2005, the Seoul High Court allowed a double derivative lawsuit, brought by former shareholders of a subsidiary company, who are now shareholders of the parent company, seeking permission to bring a lawsuit against the directors of the subsidiary company. However, the Korean Supreme Court ruled that the suit could not proceed because the KCC allows only a shareholder of the company which has been sued to file a derivative suit on behalf of the company. The statutory language does not cover a suit by a shareholder of a parent company of a company on whose behalf the case is brought.[351]

The proposed amendments to the KCC may include the ability of shareholders of a parent company to bring a double derivative suit. If adopted, this could be important in practice. Self-dealing occurs very often through the subsidiary companies of public companies. At present, the mother company will not sue the directors of its own subsidiaries, and shareholders of the mother company cannot bring this suit because they are not shareholders of the subsidiary, even though the self-dealing has harmed their interests as shareholders of the mother company, by reducing the value of the subsidiary.

351 Case No. 2003-Da-49221.

Korea's principal rules for derivative suits are set forth in the following sections of the KCC.

Article 402 (Right to Injunction)

If a director commits an act in contravention of laws and subordinate statutes or the articles of incorporation and such an act is likely to cause irreparable damage to the company, the auditor or a shareholder who holds no less than 1/100 of the total issued and outstanding shares may demand on behalf of the company that the relevant director stop such an act.[352]

Article 403 (Derivative Suit by Shareholders)

(1) Any shareholder who holds no less than 1/100 of the total issued and outstanding shares may demand that the company file an action against directors to enforce their liability.

(2) The demand under paragraph (1) shall be made in writing, stating the reasons thereof.

(3) If the company has failed to file such action within 30 days from the date on which the demand under paragraph (2) was received, the shareholder mentioned in paragraph (1) may immediately file such action on behalf of the company.

(4) If irreparable damage may be caused to the company with the lapse of the period set forth in paragraph (3), the shareholder mentioned in paragraph (1) may immediately file such action, notwithstanding paragraph (3).

(5) The effect of institution of an action shall not be prejudiced even where the number of shares held by a shareholder who files an action under paragraphs (3) and (4) comes to be under 1/100 of the total issued shares after the institution of the action (excluding where he no longer holds the issued shares).

(6) Where an action is filed under paragraphs (3) and (4), the parties concerned shall not render the withdrawal, renunciation or admission of the claim, or settlement, without permission from a court.

(7) The provisions of Articles 176 (3) and (4), and 186 shall apply mutatis mutandis to the action under this Article.

Article 404 (Derivative Suit and Intervention, Notice of Action)

(1) The company may intervene in the actions under Article 403 (3) and (4).

(2) The shareholder who has filed an action under Article 403 (3) and (4) shall immediately effect a notice of an action to the company.

Article 405 (Rights and Duties of Shareholder Filing Action

(1) If the shareholder who has filed an action pursuant to Article 403 (3) and (4) wins the case, he may demand the reimbursement by the company for the action cost and a reasonable amount of other expenses disbursed for the action. In such

352 The demand is generally made through a letter to the director and, at the same time, filed with the court.

case, the company which has paid the expenses for action shall have a right to indemnity against the directors or auditors.

(2) If the shareholder who has filed an action pursuant to Article 403 (3) and (4) loses the case, he shall not be liable for damages to the company, except for the malicious intent.

Article 406 (Derivative Suit and Action for Retrial)

(1) In case where the plaintiff and defendant in an action under Article 403 have caused a judgment to be rendered by their collusion for the purpose of fraudulently injuring the rights of the company, which is the subject-matter of the case, the company or shareholders may institute an action for retrial against the final and conclusive judgment.

(2) The provision of Article 405 shall apply *mutatis mutandis* to the action under paragraph (1).

United Kingdom

The topic of derivative suits is very politically sensitive in the UK at the moment. The basic position in English law is that directors' and managers' duties are owed to the company.[353] As a result, the company is the proper plaintiff to bring an action claiming that there has been a breach of duty.[354]

"Derivative actions" are currently a limited exception to the basic "proper plaintiff" rule, in which the court, exercising its general "equity" powers to do justice in a particular case, may permit a shareholder to bring an action on behalf of the company for the company's benefit when the persons normally responsible for making litigation decisions on behalf of the company (generally the board) improperly decline to sue. The circumstances in which this can be done under present English law are so obscure and difficult to establish that the derivative action is virtually non-existent in England.[355] For this reason, and also because the Companies Act 2006 has replaced this arcane case law, there is no point in discussing further the existing English law of derivative actions.

Sections 260-264 of the Companies Act 2006 create a new statutory scheme, in which a court can allow a derivative action to proceed if, after a shareholder institutes proceedings on behalf of the company, the shareholder convinces the court that it is appropriate for the suit to continue, at an early pre-trial hearing. The shareholder bears the burden of proof. The following text, from § 263, sets out the key matters for the court to consider:

(2) Permission (or leave) must be refused if the court is satisfied—

353 *Percival* v. *Wright* [1902] 2 Ch. 421.

354 *Foss* v. *Harbottle* (1843) 2 Hare 461.

355 See generally Law Commission for England and Wales, *Shareholder Remedies*, Consultation Paper No. 142 (1996); Law Commission for England and Wales, *Shareholder Remedies*, Final Report No 246 (1997).

(a) that a person acting in accordance with section 173 (duty to promote the success of the company) would not seek to continue the claim,[356] or

(b) where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorised by the company, or

(c) where the cause of action arises from an act or omission that has already occurred, that the act or omission --

(i) was authorised by the company before it occurred, or

(ii) has been ratified by the company since it occurred.

(3) In considering whether to give permission (or leave) the court must take into account, in particular --

(a) whether the member is acting in good faith in seeking to continue the claim;

(b) the importance that a person acting in accordance with section 158 (duty to promote the success of the company) would attach to continuing it;

(c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be --

(i) authorised by the company before it occurs, or

(ii) ratified by the company after it occurs;

(d) where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company;

(e) whether the company has decided not to pursue the claim;

(f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.

(4) In considering whether to give permission (or leave) the court shall have particular regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter.

While enactment of this new procedure will clarify the law governing derivative litigation, the utility and desirability of the new provisions is very contentious. On the one hand, the new law does nothing to address the practical financial disincentives for shareholders to bring derivative suits. In other words, recovery in such an action is for the benefit of the company as a whole, not the shareholders bringing the action. Yet those shareholders bear the risk of paying all the costs of the action if they lose. Therefore it may be that the new law will not have much effect. This view is supported

356 This language is clumsy, but the idea is that the shareholder must persuade the court that it is in the company's interests to pursue the claim.

by the cross-country analysis of director liability by Black and Cheffins, who report that these disincentives are very important in practice, in discouraging derivative suits.[357]

On the other hand, companies (particularly those in politically sensitive sectors, such as energy, natural resources, etc.) are concerned that the new provisions will strengthen the hand of those who acquire shares in a company in order to harass management by bringing derivative actions, which will have to be defended, even if they are ultimately dismissed, with a view not to obtaining financial redress but in order to cause the company embarrassment and/or change its business behavior.

To do this would amount to an abuse of the derivative action. The derivative action exists to permit the company to obtain a remedy when it, through its management, cannot directly obtain the remedy itself.[358] However, proving such abuse and getting the action dismissed may be difficult in practice. A 2006 survey of directors of publicly quoted companies found that 54% were "very concerned" or "quite concerned" that the proposed change to the law would cause the number of claim against directors to increase.[359]

United States

We describe here Delaware law with regard to suits brought by shareholders, seeking damages for breach of fiduciary duty by directors. This law is principally common law, established by judicial decisions. The procedural rules in some other states may differ.[360]

The United States addresses the question of who should control a lawsuit against directors -- the company (which often will choose not to bring a suit) or shareholders -- through extremely complex procedural rules governing when a suit brought by shareholders in the name of the company can proceed. To oversimplify greatly, in theory, a shareholder who wishes to bring a suit must first demand that the corporation bring it, and then can seek to bring it if the corporation refuses, but will face a petition from the corporation asking the court to dismiss the suit. However, in practice, the act of making this demand is deemed to concede that the corporation's board of directors is sufficiently independent to decide on the merits whether the suit should be brought.

To avoid this concession, which as a practical matter will remove almost all chance that the court will permit the lawsuit to proceed, shareholders instead file a derivative suit in court, and then claim that they should be permitted to do so because the corporation's board of directors is conflicted so that a demand would be futile. The board of directors of the corporation predictably then meets (or at least the directors who are not directly conflicted meet), and decides the claim has no merit. The corporation then petitions the

357 Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEXAS LAW REVIEW 1385-1480 (2006).

358 *Atwool* v. *Merryweather* (1867) L.R. 5 Eq. 464n; *Prudential Assurance Co. Ltd.* v. *Newman Industries Ltd.* (*No. 2*) [1981] Ch. 257 and [1982] Ch. 204; *Barrett* v. *Duckett* [1995] 1 BCLC 243.

359 Herbert Smith, *Survey Related to Directors Duties and Insurance: Summary Report* (2006), *at* http://www.herbertsmith.com/Publications/archive/2006/DirectorsDutiesSummaryReportJuly2006.htm.

360 For details, see WILLIAM ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION ch. 10 (2nd edition, 2007).

court to dismiss the shareholder claim. The court then holds a preliminary inquiry into the independence of the directors who have determined that the case should not proceed.

If the court finds that the directors are independent, then demand was not futile and the derivative suit will be dismissed. If the court finds that the directors are not independent, the court may allow the claim to proceed. One basis on which the court can find that the directors were not independent is whether it appears to the court that the claim is likely to be meritorious. The court then infers, from the fact that the corporation wants to dismiss this likely valid claim, that the directors must not be independent.

This is a crazy system for determining which derivative suits can proceed. Academics criticize this approach, and one would not recommend it to anyone else. Experience with the weaknesses of this system led Black and Kraakman, during the period when the Russian law on joint stock companies was being drafted, to propose the much simpler system which Russia adopted, in which a derivative suit can proceed if brought by shareholders holding a minimum percentage of the company's shares.[361]

While the procedural rules governing whether a derivative suit can proceed are complex, the practical reality is that a suit with substantial merit has a decent chance of being allowed to proceed. Other aspects of U.S. procedural rules are relatively favorable in providing incentives for plaintiffs' lawyers to bring these suits, assuming they can find a willing plaintiff shareholder (which is usually possible).

First, contingency fees are possible. Second, each side bears its own expenses. Third, the company will be expected to reimburse the reasonable legal fees if the shareholder suit is successful. Thus, it is feasible for lawyers to accept a case, on a contingency fee basis, so that the shareholder plaintiff is not at risk of having to pay legal fees, whether the case succeeds or not. If the suit succeeds, the compensation to the lawyers will be determined by the court, but will be based in significant part on the remedy achieved, rather than the number of hours worked.

This overall set of rules allows a law firm to recover enough in fees in successful cases to cover its cost from bringing unsuccessful cases without compensation, as long as it exercises reasonable judgment overall on which cases are worth bringing. The prospect of recovering fees provides lawyers with an incentive to pursue derivative litigation when plaintiff shareholders would not otherwise bother. Indeed, some critics argue that lawyers' incentives are too strong, and result in many weak cases being brought.[362]

Fourth, the overall frequency of both derivative litigation under corporate law and securities litigation is high enough so that companies routinely purchase directors' and officers' liability insurance, to cover their directors and officers. This insurance then provides a "deep pocket" which can provide a source of payment, without the need to chase the assets of individual directors and officers.

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361 Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARVARD LAW REVIEW 1911-1981 (1996), at http://ssrn.com/abstract=10037.

362 See, for example, Roberta Romano, The *Shareholder Suit: Litigation Without Foundation?*, 7 JOURNAL OF LAW, ECONOMICS AND ORGANIZATION 55-87 (1991).

In practice, most derivative suits that proceed past the preliminary stage discussed above are settled. The settlement agreement will typically recite that the suit has conferred a "substantial benefit" on the corporation, and the corporation will agree to pay the plaintiffs' attorneys' fees. Judges must approve settlements, but they rarely object to the parties' agreement on fees.

Summary and recommendations

The Russian JSC Law provides a reasonable procedure for shareholders to bring a derivative suit. The general approach in JSC Law art. 71, of permitting a suit provided that it is brought by shareholders holding a specified percentage of a company's shares, is similar to the approach in several of the comparison countries. The requirement for holding 1% of a company's shares appears to be reasonable.[363] However, a number of practical issues have arisen that impede the effective use of the derivative suit procedure.

General courts or arbitrazh courts

One issue in Russia, which has no parallel in the comparison countries, arises from the existence in Russia of two separate systems of courts, the regular civil courts and the arbitrazh courts. The arbitrazh courts have exclusive jurisdiction over disputes between legal entities. For disputes involving shareholders who are physical persons, however, both sets of courts have jurisdiction.

We recommend that the either the JSC Law or the Arbitrazh Procedure Code should provide that disputes involving joint stock companies and their shareholders should be heard exclusively by the arbitrazh courts, who have greater expertise in commercial disputes.

Similar rules for bringing actions under different provisions of the JSC Law

As we discuss above (subchapter 1.7), we believe that the remedies available to shareholders should be similar under JSC Law art. 71 (duties of directors and managers) and art. 84 (completion of a self-interested transaction). We also believe that the procedural rules applying to suits under these two provisions should govern. At present, to bring an action under JSC Law art. 71, a shareholder must hold at least 1% of the company's shares. There is no similar requirement under JSC Law art. 84. We believe that the requirement that a shareholder hold 1% of the company's shares is appropriate for actions brought under both provisions. The requirement of a minimum shareholder strikes a balance between allowing shareholder suits, and reducing the risk of nuisance suits, brought by a shareholder without a real economic interest in the company, where the goal of the suit is not to achieve a recovery for the company but instead to achieve a personal benefit for the shareholder. We understand that suits are sometimes brought in Russia, where the underlying goal is to put pressure on the company to purchase the

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363 On the potential problems raised by a substantially higher percentage requirement for bringing a derivative suit, such as the 5-20% levels found in a number of European countries, see Kristoffel Grechenig and Michael Sekyra, *No Derivative Shareholder Suits in Europe - A Model of Percentage Limits, Collusion, and Residual Owners* (working paper 2006), at http://ssrn.com/abstract=933105.

shareholder's shares at an above-market price. We therefore recommend that a 1% shareholding requirement be added to JSC Law art. 84.

,th other areas of the JSC Law in which nuisance suits have been a problem, or in which shareholders do not currently have an effective remedy we also recommend that:

- only shareholders holding 1% of a company's shares can bring a suit under JSC Law art. 49(7) to invalidate a decision by a general shareholder meeting; and
- shareholders holding 1% of a company's shares should be permitted to bring a suit to invalidate a decision of the board of directors, adopted in violation of the requirements of the JSC Law, other laws or legal acts, or the company's charter.

The proposed new right of a shareholder to sue to invalidate a decision of the board of directors should be subject to limits similar to those which currently apply to the right of a shareholder to sue to invalidate a decision of a general shareholder meeting. In particular:

- the shareholder should be required to prove that the decision violates his rights and legal interests;
- the petition should be filed with a court within six months from the day on which the shareholder became aware or should have become aware of the adopted decision; and
- the court should have the right, taking into account all the circumstances of the cas,e to leave the appealed decision in force, if the committed violations are not significant and the decision did not cause losses to the given shareholder.

Attorney fees in successful derivative suits

However, the rules on attorney fees provide a potential obstacle to such a suit. Suppose that the suit is successful. The recovery will be paid to the company. The shareholder plaintiff will be entitled to recover court costs and reasonable attorney fees from the defendants. However, in practice, the amount of attorney fees that the court is likely to award under this standard will represent a fraction of the actual cost to hire counsel with the expertise to bring such a suit.

The court practice of awarding only a fraction of actual legal expenses exists in a number of the comparison countries as well. It is beyond the scope of this report to evaluate whether this practice should be changed in general, to provide for full compensation for legal expenses.

We recommend instead that if a shareholder brings a successful derivative suit, the company should pay the shareholder's reasonable expenses to bring the suit, including reasonable attorney fees at customary commercial rates in the common situation in which the court awards fees at a lesser rate or in another way limits the recoverable fees to less than the amount of expenses that the shareholder incurred in accordance with customary commercial practice, including retaining counsel with expertise in bringing suits under the JSC Law, less any amounts the shareholder recovers from the defendants. The policy justification for this rule is that the shareholder has brought, on behalf of the company, a suit that the company should have brought on its own behalf. If the company brought the suit directly, it would of course pay its own counsel, at commercial rates. Thus it is appropriate to require the company to reimburse the shareholder for reasonable legal expenses, measured at commercial rates if the suit is instead brought by a shareholder.

Framing this recommendation presents a challenge, since in theory the courts already award "reasonable" expenses to the winning party. We recommend that the JSC Law be amended to provide that the company should reimburse the shareholder's expenses, incurred at customary commercial rates and in accordance with ordinary business practices, to the extent these expenses are not paid by the losing party.

Attorney fees in unsuccessful derivative suits

In many countries, an important obstacle to the bringing of a derivative suit is the risk of having to pay attorney fees for both sides if the case is not successful. The plaintiff faces the following dilemma. If the suit is successful, the recovery will go to the company. At best, if our proposal above is accepted, the plaintiff will recover his attorney fees from the company, and will realize a small, indirect benefit because of the recovery received by the company. If, however, the suit is unsuccessful, the plaintiff will be required to pay the legal expenses of both sides. Faced with such a choice, many shareholders will choose not to bring a derivative suit, even if they have good prospects of success.

To provide shareholders with a more attractive balance of benefits and cost, we recommend that, if a suit is unsuccessful, the shareholder should be liable to pay the defendants' legal costs only if the court also finds that there was no reasonable basis for bringing the suit. If the judge decides that there was a reasonable basis for bringing the suit, even though the suit did not succeed, then each side should pay its own attorney fees and other expenses.

The Arbitrazh Procedure Code already provides a procedure for sanctions against a party who has brought a claim under circumstances which the court considers to be an abuse of the general right to bring a suit. The concept of abuse of right can be employed here as well. We recommend that the plaintiff shareholder should be responsible for paying the defendants' legal expenses only if the court finds that it was an abuse of right to bring the suit.

To ensure that directors and managers are not responsible for their legal and other expenses, following a successful defense against a derivative suit, we recommend that the company should have the power to compensate them for these expenses. We discuss compensation for legal expenses in Subchapter 9.1.

Participation by the company in a derivative suit

When a shareholder brings a suit, the company may sometimes seek to participate in the proceedings. The company will claim, reasonably, that it is the beneficiary of the lawsuit, and should be entitled to participate in some way. At the same time, experience suggests that, in many cases, if allowed to participate, the company will seek to lose the case rather than win it, or seek to complicate the case to reduce the chances that the shareholder will succeed. This concern is especially acute when the underlying concern is completion of a conflict-of-interest transaction. The directors who approved the transaction can hardly be expected to authorize the company to sue themselves for having approved it. Concerns about whether the company will vigorously pursue a case against its own director or managers are the justification for allowing a derivative suit in the first instance.

We recommend that this situation be addressed as follows. The JSC Law should be amended to specify that the suit is brought in the name of the shareholder-plaintiff, with the company considered as a third-party beneficiary. This will clarify that decisions about the litigation should be made by the shareholder and not by the company.

We also recommend that the Arbitrazh Procedure Code be amended to provide the trial judge with discretion on what role the company should play in the proceedings.

Derivative suits by shareholders seeking personal advantage

We understand that in some cases, Russian shareholders have brought derivative suits where their real goal is not to achieve a recovery to the company, but instead to cause the company to suffer adverse publicity. The shareholder's goal is to pressure the company into acquiring his shares at an attractive price.

We have no recommendations to offer, because we do not know a good solution to this problem. The company's directors can, of course, simply defend the suit on the merits. They would find it easier to do so if they were assured that, if they are successful, their full legal expenses will be paid by the company. We discuss compensation for the directors' expenses in Subchapter 9.1.

Subchapter 8.2 Prevention of abuses in bringing proceedings against members of company management organs

Issue: How should collusion of members of company management organs with plaintiff-shareholders be prevented in a derivative suit?

Russian context

As indicated earlier, under JSC Law art. 71(5), a shareholder (shareholders) holding, in aggregate, at least 1% of the company's common shares can bring a derivative suit against members of a company's management organs. The requirement that the shareholder hold at least 1% of the company's shares reflects the desire to insulate a company from claims by "casual" shareholders who might file a suit while holding only a few shares, to achieve a personal gain rather than to advance the company's interests. The acquisition of even 1% of the shares of a company (especially a large one) is costly. This limits the possibility of bad-faith lawsuits. However, there is a point of view which seeks to increase the minimum percentage of shares which a shareholder must hold to bring a suit.[364]

In Russian judicial practice, there have been cases involving abuse by shareholders of the right to file a claim seeking compensation of losses from members of management organs. For example, a shareholder may act in collusion with a bad-faith manager who has caused losses to the company through his actions, bring a suit against him in court, and deliberately lose the suit. Other shareholders, who were unaware of the hearing, will lose the possibility of filing a future claim against the manager (Arbitrazh Procedure Code art. 150(2)).

Under the Arbitrazh Procedure Code, a hearing should proceed through specific stages. Under Arbitrazh Procedure Code art. 133, in preparing to hear the case, the judge decides who can participate in the case and considers whether to bring other persons into the case (Arbitrazh Procedure Code art. 135(1(5))). The judge has the right to involve other shareholders as third parties who do not have independent demands and to ensure that other shareholders receive notice of the hearing (Arbitrazh Procedure Code art. 51). However, this is the court's right, not its obligation. In practice, effective notice to other shareholders is often not provided. Moreover, the right to participate as a third party does not fully address the concern with a suit by a shareholder acting in collusion with a manager. Under Arbitrazh Procedure Code art. 51, third parties who do not have independent demands do not have the right to change the bases or subject of the claim, increase or decrease the scope of the claim demands, and so on. On the other hand, they do have the right to present evidence pertaining to the case.

A problem can also arise when various courts hear different shareholders' claim statements against a single company. This can lead to adoption by different courts of conflicting decisions on the same question. The solution to this problem is to combine all

364 National Council on Corporate Management, Outline of the Development of Corporative Legislation for 2008 («Концепция развития корпоративного законодательства на 2008 год», подготовленная Национальным Советом по Корпоративному Управлению, at http://corp-gov.ru/bd/db.php3?db_id=3444andbase_id=3).

claims in a single hearing. Under Arbitrazh Procedure Code art. 130(2), the court has the right to combine several like cases into a single hearing. Like cases are those which belong to a single category and in which the same persons are taking part. The bases for combining related cases in a single hearing are quite broad. Once again, though, combining cases into a single hearing is the court's right, not its obligation.

The solution to this problem as well lies in providing information to a company's shareholders about the hearing. Amendments to the Arbitrazh Procedure Code have been proposed concerning:

- Delivery of information to shareholders about a pending hearing involving a company. This would occur through notice by the court to the company about the filing of a claim against it, once the claim is accepted by the court for consideration, after which the company must inform its shareholders of the court's acceptance of the claim.
- The development of a concept of class-action suits.
- Requiring the courts to combine closely interconnected demands stemming from a single dispute involving a single company into a single hearing.

The proposed reforms would also amend the Code of Administrative Violations to establish liability of a company's official, through a fine or disqualification, for failure to notify shareholders about a lawsuit or failing to follow the notification procedure concerning corporate disputes. One may hope that an improved notice procedure will reduce the number of collusive suits.

Canada

If a company sues its own directors, the risk of a collusive settlement that largely protects the defendants and provides a minimal remedy to the company is obvious. So is the risk that the company will arrange to lose the lawsuit, in order to block an effort by shareholders to pursue the same claims.

If a suit is brought against directors as a derivative suit, there is also potential for collusion between the shareholder who brings the complaint and the company. Even a genuinely independent shareholder may be tempted to enter into a settlement with the defendants (the company's directors) that ignores the interests of the company and the remaining shareholders. There is a further risk that the shareholder will not genuinely be independent of the directors.

While these risks exist in theory, they have not been a serious problem in Canada. One reason is that suits brought under the oppression remedy are much more common than derivative suits, and collusion is unlikely for oppression suits. Oppression suits are brought directly by shareholders. A settlement between the company and one shareholder on terms that are favorable to the directors will not prevent other shareholders from pursuing similar claims.

A second reason is that Canadian corporate legislation typically provides derivative litigation cannot be discontinued or dismissed without leave of the court (CBCA §

242(2), OBCA § 249(2)).[365] If a court rejected a proposed settlement, other shareholders would likely become aware of this. Thus, a failed effort at a settlement favorable to the directors might be worse for the directors, in terms of the outcome of a later suit by other shareholders, than never having attempted a settlement at all. However, since settlements of derivative litigation have to be approved by a court in the U.S., and collusive settlement of class action and derivative suits remain a concern there, the paucity of derivative suits in Canada likely is the more important reason why collusive lawsuits are not currently a source of concern.

France

Under Code de Commerce art. 225-252, the right of a shareholder to bring a derivative suit is not waivable, either in a company's charter or by decision of a general shareholder meeting. From this, it follows that a waiver by one shareholder does not affect other shareholders.[366] These rules would be evaded by a collusive settlement. Thus, if a collusive settlement can be shown to have been made, it would probably also be disregarded. Additionally, one may also consider not only the directors' liability for the initial breach, but also their liability for agreeing to a collusive settlement. If it can be established that this agreement is a separate breach of directors' duties, this breach can be enforced regardless of the previous settlement.

The problem, of course, would be to prove that the initial settlement was collusive. Derivative suits in France are sufficiently uncommon so that there is no practical experience on this question.

Germany

Under AktG § 149 I, once a derivative suit on behalf of a public company has been permitted by the court under § 148, the application for admission must be publicized (in the German Federal Gazette [*Bundesanzeiger*]). The fact that legal proceedings have ended must also be publicized, and the publication must include the text of all agreements relating to the conclusion of the proceedings and the names of the parties. Payments made or services performed by the company or on its behalf must be described (§ 149 II). The same provisions apply to agreements reached in order to avoid legal proceedings.

Under AktG § 148 V, a verdict or settlement is binding on the firm and all shareholders. However, a settlement of a derivative suit is binding on the company only if the suit has successfully passed the admissibility stage. In principle, this might allow collusive settlements. However, under AktG § 93 IV sentence 3, the company may only waive a claim against a director or settle it at least three years after the claim arose, following approval by shareholders, and if there is not a formal objection by shareholders holding shares representing 10% of the company's share capital. AktG § 148 VI sentence 4 explicitly states that the company may only withdraw a suit in accordance with the

365 For discussion see William Kaplan & Bruce Elwood, *The Derivative Action: A Shareholder's 'Bleak House*, 36 UNIVERSITY OF BRITISH COLUMBIA LAW REVIEW 443 (2003), at 477.

366 CA Paris 14 mai 1982, BRDA 1982/17, page 11.

requirements of § 93 IV sentence 3, except that the three-year period will not apply once a suit has been brought.

In the absence of an explicit statutory provision, it has been suggested that AktG § 93 IV 3 also applies to settlements of derivative suits controlled by shareholders.[367] This interpretation probably would rule out collusive settlements. However, derivative suits have been sufficiently rare in Germany so that there is no practical experience on this question.

Italy

Under Italian law, a settlement of a derivative suit, on behalf of a company, must be approved by shareholders. The settlement will fail if more than 20% of shareholders (more than 5% in a listed company) have voted against the settlement. These are the same thresholds that shareholders need to meet in order to bring a derivative suit (see the discussion in subchapter 8.1).

Korea

Thus far, collusive settlement of a derivative and class action suit has not been an issue in Korea. Most of the derivative suits have been filed by the shareholder rights activists, i.e., for public interest. There has been no class action suit in Korea. Korea is a small country in terms of geography and its court system is highly efficient and digitally organized. The U.S.-style discovery process is also absent in the Korean Civil Procedure Act.

At the same time, KCC art. 406 expressly addresses the possibility of a collusive suit:

> **Article 406 (Derivative Suit and Action for Retrial)**
>
> (1) In case where the plaintiff and defendant in an action under Article 403 have caused a judgment to be rendered by their collusion for the purpose of fraudulently injuring the rights of the company, which is the subject-matter of the case, the company or shareholders may institute an action for retrial against the final and conclusive judgment.
>
> (2) The provision of Article 405 shall apply *mutatis mutandis* to the action under paragraph (1).

The shareholder seeking to set aside a judgment would bear the burden of proving collusion.

367 Handelsrechtsausschuss des DAV, Stellungnahme zu dem Regierungsentwurf eines Gesetzes zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG), 8 *Neue Zeitschrift für Gesellschaftsrecht* 388, 391 (2005); UWE HÜFFER, AKTIENGESETZ ¶ 148, § 20 (7th edition, 2006).

United Kingdom

In the U.K., the prevention of collusive suits is a matter for the courts to address, in exercise of their general power to prevent abuse of their own procedures. A derivative action may only be brought by a shareholder seeking in good faith a remedy for a wrong done to the company, for which redress in the ordinary way – the company suing in its own name – is not feasible. Any other use of a derivative action amounts to an abuse of the process of the court and the court should, in theory, reject the petition to bring the derivative action.[368] So collusive actions should be thrown out of court – but the difficulty of proving collusion may be very great.

There is no specific means of stopping a collusive settlement of a derivative action. The settlement does not require court approval. Proposals to require court approval have been made but not yet implemented.[369] Trying to re-open a collusive settlement or discontinuance would therefore be very difficult and would have to rely on general principles of law, untested in this context, through which a party (the company) who is a victim of a collusive transaction can seek to set the transaction aside.

At present, the rarity of derivative actions means that the problem of collusive actions and settlement or intentional loss of such actions is not significant. That could change in light of the proposed reforms to the law concerning derivative actions (see the discussion of these reforms in subchapter 8.1). Suggestions on how to deal with the potential problem of collusive litigation through procedural rules of court were made by the Law Commission for England & Wales.[370] Some reforms concerning this issue may well be adopted once the changes to the substantive law governing derivative actions in the Companies Act 2006 come into force. The principal reform proposed by the Law Commission would give the court much more control over the procedures through which derivative suits are brought, and the manner in which they are settled.

United States

The problem of collusive settlement of a lawsuit is a significant problem in the U.S., with respect to both derivative lawsuits and shareholder class action lawsuits. The concern is typically not direct collusion between the company and the plaintiff, but instead concern that plaintiffs' lawyers will bring a case and then settle it, often quickly, receiving substantial attorney fees but not a very good recovery for shareholders.[371]

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368 *Barrett* v. *Duckett* [1995] 1 BCLC 243.

369 See Law Commission for England and Wales, *Shareholder Remedies*, Consultation Paper No. 142 (1996), §17.10; Law Commission for England and Wales, *Shareholder Remedies*, Final Report No. 246 (1997), § 6.107.

370 Law Commission for England and Wales, *Shareholder Remedies*, Final Report No. 246 (1997), annex containing draft Civil Procedure Rule 50.

371 On the incentives of plaintiffs' counsel, see, for example, John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUMBIA LAW REVIEW 669-727 (1986).

One response involves court procedure. The court must hold a hearing and approve any settlement, including the amount of attorney fees to be paid to plaintiffs' counsel. Advance notice of the hearing must be sent to all shareholders. Shareholders who are not satisfied with either the amount of the recovery or the amount of fees to be paid to the lawyers out of the recovery may appear in court and object to the terms of the settlement. The judge may also reject the settlement even without an objection.

Both responses are reasonably common. Intervention by shareholders is often effective. It is less common for a judge to reject a settlement to which no one has objected, but there are instances in which this has happened as well, where the judge was disgusted with a proposed settlement that provided large fees to the plaintiffs' lawyers and no meaningful relief to shareholders.

In the area of securities class actions, additional reforms were undertaken. The Private Securities Litigation Reform Act of 1995 creates a presumption that the shareholder holding the largest number of shares, typically a major institutional investor, should presumptively be the lead plaintiff in a class action, assuming the shareholder is willing to play this role. The lead plaintiff is then responsible for managing the litigation and negotiating a fee arrangement with counsel.

Experience with these provisions has generally been positive. There is evidence that recoveries in securities class actions have increased, and the fees paid to plaintiffs' lawyers as a percentage of the recovery have decreased, in cases where a lead plaintiff has been appointed.[372]

The United States has not experienced a significant problem with collusion between the plaintiff and defendants in litigation under corporate or securities law. The concern has instead been with the behavior of plaintiffs' counsel, who undertake litigation on a contingency fee basis, and thus are, in a sense, paid by the defendants. However, some of the approaches used to address collusion between plaintiffs' lawyers and defendants may be relevant in addressing the risk of collusion between plaintiffs and defendants.

Summary and recommendations

There is limited experience in the comparison countries with collusive derivative suits, which prevent a later meritorious suit from being filed. However, the experience in the United States with collusion between plaintiffs' counsel and defendants in class action lawsuits can provide some useful guidance.

There are several remedies, which can potentially reduce the risk of a collusive suit. These include notice to all shareholders and an opportunity to participate in the suit; an opportunity for shareholders to elect not to be bound by the outcome of the suit, disclosure by the plaintiff-shareholder, potential liability of the company's directors for procuring a collusive settlement or dismissal of a suit, shareholder approval of a

372 See Michael Perino, *Institutional Activism through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions* (working paper 2006), at http://ssrn.com/abstract=938722.

settlement, and judicial review of a settlement agreement. We address each of these in turn.

Notice of lawsuits

We recommend that all shareholders should receive written notice of a derivative suit, at the address they report to the share registrar, so that they have an opportunity to participate in a derivative suit or potentially an opportunity to opt out of being bound by the outcome of the suit. We recommend that the expense of this notice should be borne by the company, in order not to impose additional expense on a shareholder who has brought a proper derivative suit (we discuss the need to limit shareholders' exposure to the costs of derivative suits in Subchapter 8.1). Given that most lawsuits proceed slowly in any case, it should be possible in most cases to combine the notice with a separate mailing to shareholders, to reduce the expense to the company of providing the notice.

As a practical matter, it will not make sense for small shareholders to participate in a derivative suit. Thus, if the cost of providing notice is an issue, the company could provide notice only to shareholders who hold more than a threshold number of shares, such as the lesser of shares valued at 1 million rubles (this amount should be adjusted for inflation), or 0.1% of the outstanding shares.

We recommend that shareholders should have an opportunity to respond to the initial notice, and ask to be informed of significant developments in the suit. The courts will need to develop a procedure for providing this notice. In a court system in which filings by the parties are available electronically, shareholders can simply be given access to the filings. Until such time as the Russian courts adopt such an online system, a more cumbersome procedure will be needed. We lack expertise to propose details on how such a system should operate.

In addition to the notice of the suit itself, we recommend that all shareholders, or at least all significant shareholders, should receive notice of a proposed settlement or dismissal of the suit (or significant portions of the suit). These shareholders should then receive an opportunity to object to the settlement or dismissal, both in writing and by appearing in court to argue against the settlement or dismissal.

Opportunity to opt out

In the context of a class action suit, it is customary to give potential members of the class the right to opt out of the class action, and preserve their right to bring an individual action. We recommend a similar procedure for derivative suits, with some modifications due to the special nature of the derivative suit. The recommendation in subchapter 8.1, under which the suit is considered to be brought by a shareholder, with the company as a third-party beneficiary, is consistent with the right of an individual shareholder to elect not to be bound by the outcome of the suit.

In a typical class action suit, a potential class member who opts out receives a recovery only if the class member later pursues a separate individual suit. Thus, there is a cost associated with opting out. In contrast, with a derivative suit, the recovery is paid to the company, so a shareholder who opts out will receive the same benefit as a shareholder who does not opt out. For an opt out procedure to work, there must be a disincentive of some sort, to discourage shareholders from opting out and pursuing their own actions.

We recommend the following approach. If a shareholder opts out, and later brings a separate derivative action, the recovery in the separate action will be reduced by the recovery in any earlier action, since the defendants should not have to pay the same damages twice. The separate action will be considered to be successful only if the damages equal at least 120% of those obtained in the prior action. Otherwise, the separate action will be considered unsuccessful and the plaintiff-shareholder should be responsible for paying the legal costs of the defendants, in accordance with the usual rules. The second action will *not* benefit from the rules proposed in Subchapter 8.1, under which a plaintiff-shareholder would not be required to pay the defendants' legal expenses if the court finds that there was an abuse of trust in bringing the suit.

Disclosure of conflicts

We recommend that a shareholder who brings a derivative suit should be required to disclose any direct or indirect relationship with the defendants that might affect his independence and incentive to pursue the suit vigorously. In connection with a settlement of a suit, the shareholder should be required to certify to the court that, except as disclosed, he has received no personal consideration, not provided to all shareholders.

A shareholder who brings a derivative suit is acting on behalf of all shareholders. We recommend that if a shareholder provides incomplete or false disclosure or certification, he should be liable for damages suffered by the company, measured by the difference between the damages the company would have recovered in a proper lawsuit and the damages actually recovered.

Duty of directors and managers

It should also be considered to be a violation of a director's duty of good faith to participate in a collusive lawsuit, or to provide a personal benefit to a plaintiff-shareholder in connection with settling such a suit. It will be difficult to prove a violation, and also difficult to prove damages, but the theoretical case for such conduct to be considered to be a violation of the duty of good faith is clear.

We do not have a specific recommendation on legal language on this point. We consider instead that this can be left to the court to address, if an appropriate case arises.

Shareholder approval of a settlement

We recommend the Italian approach, in which non-interested shareholders must vote to approve a settlement of a derivative suit, deserves consideration. Requiring approval of a settlement by shareholders assumes that a settlement has been offered. It will not solve the problem of a plaintiff intentionally losing a derivative suit in court. However, this requirement can still be useful when a settlement calling for nominal consideration is arranged.

Review by the court

We recommend that the courts should have the power to review settlements of derivative suits, and that they should be encouraged to do so. In a usual suit, there is little reason for the courts to police the terms of a settlement. The potential for a settlement of a derivative suit to be on terms that are adverse to minority shareholders justifies a more active role for the court in these cases.

As a practical matter, even if the courts have the power to review a settlement, they will be unfamiliar with the role of reviewing settlements for fairness, and perhaps unfamiliar with derivative suits in general. Moreover, a busy judge who undertakes a serious review of a derivative suit is imposing more work on himself, for little reward. Thus, the courts will rarely reject a settlement. Still, providing them with this power is desirable.

If the plaintiff moves to dismiss a derivative suit, or a significant portion of the suit, we recommend that the court should again have discretion to reject the dismissal. However, as a practical matter, this power, even if granted, will rarely be exercised.

Subchapter 8.3 Powers of regulator in respect to judicial proceedings in connection with liability of members of company management organs

Issue: Which powers does (should) the regulator of financial markets have in the area of imposing liability on members of management organs for breach of duty to the company, established by company law, through bringing or participating in judicial proceedings?

Russian context

Russian law provides only limited powers to the Federal Service on the Financial Market or another regulator to bring claims for damages against members of company management organs, or to participate in a dispute brought by the company or shareholders. The Arbitrazh Procedure Code generally establishes the possibility of filing a claim only to protect one's own rights (Arbitrazh Procedure Code art. 4). State bodies have the right to participate in a hearing as plaintiffs only to protect public interests (Arbitrazh Procedure Code art. 53).

The Civil Procedure Code provides broader rights to state bodies. It permits state bodies to file a claim statement to protect the rights and interests of other persons (including an unspecified group of persons) (Article 46) and to participate in the case by providing testimony (Article 47). A claim brought to protect the rights of an unspecified group of persons has some similarities to a class action. However, under Civil Procedure Code art. 46, a state body has the right to file statements to protect the rights and legal interests of other persons only when this is provided for by law. The JSC Law does not convey this right to the FSFM or another regulatory body. There is the further question of whether the regular courts have jurisdiction in suits against members of company executive bodies seeking damages for their wrongful management of the company, or whether the arbitrazh courts have exclusive jurisdiction over these claims.[373]

Under Civil Procedure Code art. 47, state bodies can, on their own initiative or on the initiative of persons participating in the case, provide testimony in a case, if this is provided for by federal law. The FSFM again is not given this power under federal laws. Civil Procedure Code art. 47(2), however, also permits a court, when circumstances require, to involve a state body in a case.

In sum, under current legislation, there is only a narrow possibility for the FSFM to participate in a case. The case must be brought in the regular courts, in which case, the FSFM can provide testimony at the initiative of the court.

Canada

Under the CBCA, the public officials in charge of administering corporate legislation (which the legislation refers to as "the Director" for the sake of convenience) qualify as complainants (CBCA § 238). Thus, if a company is incorporated under the CBCA, the Director has standing to seek civil remedies under the derivative action and the oppression remedy.

373 We discuss which courts have jurisdiction over these disputes in subchapter 8.1.

The OBCA does not contain comparable language (OBCA § 245). This means that, for a corporation that is incorporated under the OBCA, the OBCA Director has no specific power to bring a civil action for breach of duty under company law. The OBCA Director could potentially bring a derivative suit or oppression remedy suit under the OBCA if the court could be convinced that, under the definition of "complainant" in OBCA § 245, the Director was a "proper person" to apply for leave to bring such a suit. We are not aware of efforts by the Director to bring civil actions under the OBCA.

Provincial securities regulators in Canada have no power to enforce breaches of duty by directors under company law. Nor is there any other regulator with this power. However, breaches of duty to the corporation that are sufficiently serious to give rise to criminal penalties can be prosecuted as criminal offenses (see chapter 13).

France

The French regulators of financial markets cannot bring or participate in judicial proceedings regarding enforcement of the duties of directors under company law.

Germany

The Financial Market Authority cannot bring or participate in judicial proceedings regarding enforcement of the duties of directors under company law.

Korea

There is (should be) no way for governmental agencies to participate in a private lawsuit brought by shareholders against directors. Government agencies cannot directly bring a lawsuit either. In Korea, directors owe their fiduciary duties to the company and shareholders (perhaps to the creditors), not to the general public and the government. Thus, there is no mechanism for the regulator of financial markets to enforce the fiduciary law on members of management of private firms.

United Kingdom

The Financial Services Authority does not have the power to enforce directors' duties arising under the common law, the Companies Act 1985, or the Companies Act 2006. Nor is there any other regulator with this power. Breaches are enforced either by private parties or, in limited cases as discussed in a later chapter, by the prosecutor as criminal offenses.

United States

The Securities and Exchange Commission does not have the power to enforce directors' duties arising under the common law or state corporation statutes. Nor do Delaware or other states have state level regulators with this power. On occasion, the Securities and Exchange Commission may ask for permission to participate in an important private lawsuit as an "amicus curiae" (friend of the court), in order to express its opinion about the legal issue before the court.

At the same time, as noted in the general overview of United States law, important aspects of what might be considered to be company law in other countries are part of federal securities law in the United States, including the Sarbanes-Oxley Act. The Securities and Exchange Commission has the power to enforce the securities laws by bringing civil lawsuits. In limited circumstances, it can also apply administrative penalties.

Summary and recommendations

In some comparison countries, there is criminal liability for at least some violations of company law. This creates the potential for criminal enforcement by the prosecutor (see Chapter 13). It is less common to find a regulator with the power to bring a civil enforcement action under company law. However, the officials in charge of company law have this power in Canada, at least under the CBCA. The Australian Securities and Investment Commission (ASIC) has similar powers.[374] There are countries where the government has neither civil enforcement nor criminal enforcement powers. However, the securities regulator typically has civil enforcement power for violations of securities law, including provisions of securities law that overlap with the subjects usually covered by corporate law. We summarize the powers of the financial regulator with respect to breach of duty by directors and managers under company law in table form below, in subchapter 12.1.

As discussed in Chapter 13, we do not recommend that the regulator of financial markets have direct power to enforce criminal liability for breach of duty to the company under company law. Whether to provide for civil enforcement by the securities regulator is a closer question, in our view. One compromise would be to provide this authority to the regulator of securities markets, but limit it to public companies. We do not recommend such authority, but neither do we recommend against it.

We note that under Russian law, the prosecutor already has the power to bring such an action. Thus, if the FSFM believes that such an action is appropriate, it already has the opportunity to persuade the prosecutor to bring such an action, including providing any assistance the prosecutor may request. The extra value of the FSFM having the power to bring such a case directly, in circumstances when it would otherwise not be able to convince the prosecutor to devote resources to this effort, is likely to be limited.

We note also that for public companies, the FSFM already has substantial regulatory authority, through its power to require delisting of a company that violates the securities law or the listing requirements for the Russian Trading System.[375]

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374 For discussion of the powers of the Australian Securities and Investment Commission under Australian law, see Brian Cheffins and Bernard Black, *Outside Director Liability Across Countries*, 84 TEXAS LAW REVIEW 1385-1480 (2006), at 1433-1441.

375 See Order of the Federal Financial Markets Service, dated 22 June 2006, No. 06-68/pz-n, "On the Acceptance of the Sub-law on the Organizational Operations on Trade on the Stock Market" (establishing listing requirements) (Приказ Федеральной Службы по Финансовым Рынкам от 22 июня 2006 г. N 06-

Chapter 9. Insurance of liability of directors and managers and compensation of directors and managers by company.

Subchapter 9.1. Compensation of directors and managers by the company in suits and other proceedings

Issue: In what circumstances should a company be permitted to compensate its directors and managers against legal and other expenses, damages, and civil or criminal penalties, for their conduct as a director or manager? In what circumstances should a company be permitted to advance legal and other expenses to a director or senior manager?

Russian context

The concept of "indemnification," while prevalent in the laws of other countries, has not been codified in Russian legislation. There is no clear answer under current law as to whether the company is permitted to reimburse a member of a management organ for expenses borne by the him in connection with a suit seeking compensation of losses caused by his wrongful actions as a company manager.

In Russian civil law, losses include legal expenses, and the recovery of losses is compensatory in nature. This means that a person who violated a right of another person is obligated to reimburse the affected party for all losses associated with the violation, including reasonable legal expenses incurred in obtaining compensation. The demand for compensation of losses can be made only to the person who violated another's right (Civil Code art. 15).[376] Thus, it is doubtful that a member of a management organ can recover losses from a party that did not violate anyone's rights -- the company itself. This violates the principle of personal liability for violation of one's obligations.

In addition, under JSC Law art. 71(5), claims are filed by shareholders on behalf of the company, and the company will receive compensation if a dispute is decided in favor of the shareholders. The general principle of the compensation of losses, established in Civil Code art. 15, is thus realized. The sense of this principle would be lost if the company were obligated to compensate a member of a management organ who had violated the company's rights for losses arising in connection with his unlawful actions.

Under the Civil Code, legal expenses are not treated differently from other losses. However, there may be a difference as a practical matter, in the case where a member of a management organ is successful in defending against a lawsuit, and does not pay damages. The company can justify paying legal expenses, to the extent these expenses are not paid by the plaintiff, on the grounds that protecting managers against this risk will help the company attract good managers.

68/пз-н «Об утверждении положения о деятельности по организации торговли на рынке ценных бумаг»).

376 We discuss the concept of losses in subchapter 1.7.

Canada

Indemnification

Under Canadian corporate legislation (e.g. CBCA § 124, OBCA § 136), a corporation may, by decision of the board of directors compensate (indemnify) a director for legal expenses whether a director wins or loses in court, as well as for amounts paid by a director to a third party pursuant to a settlement or a judgment in civil, criminal, or administrative proceedings. Indemnification can only occur, however, if a director has acted honestly and in good faith with a view to the best interests of the corporation and, in an administrative or criminal proceeding, the director had reasonable grounds for believing his conduct was lawful. For a suit on behalf of the company for breach of duty to the company, either directly or through a derivative suit, indemnification is limited to legal expenses, not damages, and requires court approval. If a director incurs legal expenses defending a claim to which he became subject because of his association with the corporation and he is exonerated, the director is entitled to indemnification for reasonable expenses from the corporation, as a matter of right.

Advancement of expenses

The CBCA specifically authorizes a corporation to advance money to a director to pay legal expenses (CBCA § 124(2)). The director must repay the money advanced if he has not acted honestly and in good faith with a view to the best interests of the corporation. No specific provision is made for circumstances where a director defaults on the obligation to repay. It is possible, however, that if a corporation's directors authorize advancing of legal expenses when it was not reasonable to do so (for example, because it should have been apparent that the director was not eligible for indemnification), and these amounts are not repaid, the directors who approved advancing expenses could be held liable to pay to the corporation the amounts advanced.[377]

The OBCA does not specifically authorize a corporation to advance money to a director to pay legal expenses. Nevertheless, there is case law suggesting that an OBCA corporation does not have to await the outcome of a proceeding to pay for a director's legal expenses. Instead, indemnification payments can apparently be made on an interim basis once the director has incurred legal expenses.[378]

France

Indemnification

As far as we could determine, the French literature on directors' liability does not address indemnification of directors by the company for damages or legal expenses.[379] However,

377 MCCARTHY TETRAULT, DIRECTORS' AND OFFICERS' DUTIES AND LIABILITIES IN CANADA 296 (1997).

378 MCCARTHY TETRAULT, DIRECTORS' AND OFFICERS' DUTIES AND LIABILITIES IN CANADA 296 (1997) (discussing *Chromex Nickel Mines Ltd. v. British Columbia (Securities Commission)* (1991), 4 Business Law Reports (2nd) 189).

379 One reason may be that directors are liable to third parties only rarely when the company is not insolvent. See DEEN GIBIRILA, LE DIRIGEANT DE SOCIETE ¶ 540 (1995); ESTELLE SCHOLASTIQUE, LE DEVOIR DE DILIGENCE DES ADMIISTRATEUR DE SOCIETES. DROITS FRANÇAIS ET ANGLAIS ¶¶ *249, 255* (1998).

D&O insurance, which has become more common in recent years (see the discussion in subchapter 9.2), can be used to cover both damages and legal expenses.[380] In view of the mandatory character of directors' liability, it is unlikely that an indemnification of the company's claims against the manager would be permissible, as this would essentially result in a waiver of the claim. Art. L. 225-253 of the Code de Commerce provides that no decision made in the shareholder meeting may have the effect of extinguishing damages claims against directors. The provision is interpreted to imply that waivers of claims by the company, including waivers before a claim has arisen are not permissible.[381]

The power of the company to indemnify directors for damages paid to *third parties*, for example in a suit under securities law, is not clear.

At the same time, directors have a general right to claim reimbursement of expenses made *in the interest of the company*. As in Germany, this is seen as a general principle of civil law, under which a principal is required to indemnify his agent (Code Civile, art. 1999).[382] In a joint stock company, this payments must be authorized by the board of directors.[383] The board will need to decide that the expenses were related to conduct by the director that is in the company's interests, and that the payment must also advance the interests of the company (*intérêt de la société*).

Advancement of expenses

Code de Commerce art. 225-43 implements a prohibition on loans given by the company to members of the board of directors (*administrateurs*), the CEO (*directeur général)*, to assistant general managers (*directeurs généraux délégués*) to permanent representatives who act on behalf of legal persons who are directors, and to certain family members of these persons. There is an exception for loans given by a bank or financial company under normal conditions.

The prohibition applies to all forms of loans.[384] It seems likely that they would be interpreted to cover the advancement of legal expenses, which a director might, depending on the outcome of a lawsuit, be obligated to return.

380 Joël Monnet, *Assurance de responsabilité. – Dirigeants sociaux,* in JURISCLASSEUR SOCIETES TRAITE, Fasc. 132-15, (Août 2003), no. 36.

381 Yves Guyon, *Administration. – Responsabilité civile des admiistrateurs,* in *JurisClasseur Sociétés Traité*, Fasc. 132-10, ¶ 129 (Octobre 2005).

382 DEEN GIBIRILA, LE DIRIGEANT DE SOCIETE ¶ 161 (1995); Dominique Bureau, *Administration. – Rémunération des administrateur,* in *JurisClasseur Sociétés Traité*, Fasc. 130-40 (Février 1999), no. 36.

383 Décret n° 67-236 du 23 mars 1967 sur les sociétés commerciales, article 93(2).

384 Dominique Bureau, *Administration. – Contrats entre les administrateurs et la société,* JURISCLASSEUR SOCIETES TRAITE, Fasc.130-50, ¶ 116 (Décembre 2004).

Germany

Indemnification

The company is never *permitted* to indemnify members of the management or supervisory board for breach of duty owed to the company under the joint stock company law. This liability, based on AktG §§ 93, 116, is mandatory, and cannot be limited in the charter or waived by either the supervisory or the management board.[385] See AktG §§ 93(4)(§3), 116.

For suits by third parties, there is no direct statutory provision addressing the company's power to provide indemnification. However, indemnification which the company is not required to provide would be regarded as something similar to a gift to the directors, which violates the principle that a company has to be run in the interest of the company and its stakeholders. As a result, it is the unanimous view of commentators that neither with respect to directors' liability to the company nor with respect to directors' liability to third persons is a decision to indemnify the directors permitted.[386]

At the same time, the company is *obliged* to reimburse the directors for damages and expenses if a director is found liable to a third person as a result of carrying out his duties at the company, but has not breached duties owed to the company.[387] Here German Civil Code § 670 is applied. It states that "if for the purpose of the execution of the mandate, the mandatory (here: the director) incurs any expenses which he may regard necessary under the circumstances, the mandator (here: the company) is bound to reimburse him." Thus, for example, if a director negligently causes harm to a third person, leading to liability under tort, indemnification would generally be forbidden. However, if the director causes harm to a third person without negligence, leading to liability under tort law, indemnification would be mandatory.

Note, however, that under German law, directors are generally not directly liable under securities law. There also seems to an understanding in German law that where an individual violates a statutory prohibition, the director should not normally be indemnified. Thus, there is no obvious class of cases involving suits by shareholders or creditors to which this obligation to provide indemnification would apply.

Usually the conduct that creates liability to a third person is also regarded as a breach of the duties owed to the company. An exception may be the situation in which a director follows a plausible interpretation of a particular legal provision, reasonably believes that

385 The mandatory nature of these provisions is a general principle of German company law. AktG § 23(5) states that "the charter may only deviate from the provisions of this law if this is explicitly provided" in a particular statutory provision.

386 See, for example, Wolfgang Hefermehl & Gerald Spindler, in 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 84, ¶ 74 (Bruno Kropff and Johannes Semler editors, 2nd edition, 2004); Klaus Hopt, in GROßKOMMENTAR ZUM AKTIENGESETZ § 93, ¶ 515 (4th edition, 1999); Hans-Joachim Mertens, in KÖLNER KOMMENTAR ZUM AKTIENGESETZ § 84, ¶¶ 76, 81 (1996).

387 BASTUCK, ENTHAFTUNG DES MANAGEMENTS 102 et seq. (1986); Schlechtriem, in DIE HAFTUNG DER LEITUNGSORGANE VON KAPITALGESELLSCHAFTEN 73-74 (Kreuzer editor, 1991); Wolfgang Hefermehl & Gerald Spindler, in 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 84, ¶ 74 (Bruno Kropff & Johannes Semler editors, 2nd edition, 2004).

he is acting lawfully and in the company's interests, and subsequently, courts hold that this interpretation was wrong and the director therefore becomes liable. Here, it is possible that there is no breach of duties owed to the company, and thus the company has to reimburse the director.[388]

Advancement of expenses

As a company is never permitted to indemnify directors, it is also not permitted to advance legal expenses. However, in the same circumstances in which the company is obliged to reimburse the directors, it is also obliged to advance legal expenses.[389]

A different question would be whether the company is allowed to grant credit to members of the management or supervisory board. According to AktG §§ 89, 113, this is possible if the supervisory board approves it.

Korea

Indemnification

The KCC is silent about indemnification or the advancing of legal expenses, and there are no court decisions addressing these questions. Korean legal scholars are skeptical whether an indemnification arrangement is legal. Nevertheless, indemnification agreements between a company and its directors are widely used in Korea. For instance, Seoul National University requires an indemnification letter from the company when a professor seeks approval from the University President to accept an outside director position. It has also been reported that foreign directors regularly request indemnification agreements from companies before agreeing to serve as outside directors.

A principal reason why legal scholars believe indemnification against liability under company law should not be available derives from the provisions of the KCC governing such liability:

> **Article 399 (Liability to Company)**
>
> (1) If directors have acted in violation of any laws and subordinate statutes or of the articles of incorporation or has neglected to perform their duties, they shall be jointly and severally liable for damages to the company.
>
> (2) If any act mentioned in paragraph (1) has been done in accordance with the resolution of the board of directors, the directors who have assented to such resolution shall take the same liability.
>
> (3) The directors who have participated in the resolution mentioned in paragraph (2) and whose dissenting opinion has not been entered in the minutes shall be presumed to have assented to such resolution.

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388 Klaus Hopt, in GROßKOMMENTAR ZUM AKTIENGESETZ § 93, ¶ 516 (4th edition, 1999); Hans-Joachim Mertens, in KÖLNER KOMMENTAR ZUM AKTIENGESETZ § 84, ¶ 76 (1996).

389 See German Civil Code § 669 (“The mandator shall on demand make advances to the mandatory for the expenses necessary for the execution of the mandate”.).

Article 400 (Release of Liability to Company)

The liability of directors under Article 399 may be released by the consent of all shareholders.

The express provision for release of liability by unanimous consent of shareholders implies that the board cannot release a director from liability. Yet, in effect, this is what an indemnification contract would do.

The argument for the legal permissibility of indemnification may be stronger for liability owed to third parties, such as shareholders, rather than to the company. However, the Korean Commercial Code is silent, so the status of indemnification agreements can only be considered to be uncertain.

Advancement of expenses

A typical indemnification agreement includes the advancing of legal expenses. However, if the facts available to the board of directors when it approves the advancing of expenses indicate that a director is unlikely to win the lawsuit, and therefore will be responsible for repaying the advanced legal expenses, such an advance payment might cause liabilities of the board members.

United Kingdom

Indemnification

A company cannot indemnify a director for a fine or administrative penalty, for a damages payment resulting from a breach of duty owed to the company, and for legal expenses incurred when losing in court in criminal proceedings or in a lawsuit brought by the company (Companies Act 1985, §§ 309A(1), 309B(3), (4), replaced by Companies Act 2006, § 234). By implication, a company may indemnify a director (i) for legal expenses if he is exonerated in criminal or administrative proceedings or in a suit brought by the company (ii) for legal expenses and any liabilities incurred in civil proceedings brought by third parties, for example, for a suit under securities law. Thus, if investors bring a lawsuit against a company and its directors alleging misdisclosure under securities law and the case settles or the directors lose at trial, the company can indemnify the directors for both damages payments and legal bills.

Advancement of expenses

While U.K. companies legislation traditionally permitted companies to indemnify expenses incurred by a director who was successful on the merits they could not reimburse directors on an interim basis for legal expenses incurred during the course of legal proceedings. The *Equitable Life* case, discussed in Chapter 11, revealed the hardship this restriction could impose. A number of Equitable Life ex-directors found themselves in acute financial difficulty as a result of having to pay legal bills personally as the proceedings dragged on. In 2004, U.K. companies legislation was amended to permit companies to advance legal expenses incurred as a case proceeds.

If a company advances payment for legal and other expenses arising from a lawsuit brought by the company or from criminal proceedings, this is treated as a loan which must be repaid if the director loses in court (Companies Act 1985, § 337A, replaced by Companies Act 2006, § 205).

United States

Indemnification

Perhaps as a result of the high frequency of lawsuits, United States corporate law *permits* companies to provide their directors and officers with relatively broad protection against paying damages, and extremely broad protection against paying legal expenses. In a suit brought on behalf of the company for breach of duty under company law, including derivative suits, the company may indemnify directors for legal expenses but not for damages. For suits by third parties, including suits under corporate law brought directly by shareholders and suits under securities laws, the company may indemnify directors and officers for both damages and legal expenses.

More specifically, under Delaware law, the corporation may indemnify a director or officer for expenses in a suit claiming breach of duty under company law, brought by or on behalf of the company (in other words, the company may decide not to demand repayment of the legal expenses which have been advanced), if the director "acted in good faith and in a manner the [director] reasonably believed to be in or not opposed to the best interests of the corporation."[390] The Model Business Corporation Act provides even broader rights to indemnification.[391]

In a direct suit by shareholders or other third parties (that is, a suit not brought by or on behalf of the company), both expenses and damage awards are indemnifiable, again subject to the requirement that the director or officer act in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation.

If damages are awarded in a suit by the company, or a derivative suit brought on behalf of the company, indemnification for expenses is only available if the judge finds this to be appropriate.[392] But damage awards against directors are rare, because of the separate

390 Del. Gen. Corp. L. § 145(a) addresses indemnification for direct (non-derivative) suits and provides that "A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any . . . action suit or proceeding [other than a derivative suit] by reason of the fact that the person is or was a director . . . or was serving at the request of the corporation as a director . . . of another [entity], against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person . . . if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation . . . .". Del. Gen. Corp. L. § 145(b) addresses derivative suits and is worded similarly to § 145(a), except that it permits indemnification only for legal expenses, not for judgments, fines and amounts paid in settlement.

391 Under the Model Business Corporation Act, a company's charter may permit or require indemnification and advancement of expenses for all actions except "(A) receipt of a financial benefit to which [the director] is not entitled; (B) an intentional infliction of harm on the corporation or its shareholders; (C) [an improper dividend or share repurchase]; or (D) an intentional violation of criminal law." Model Bus. Corp. Act § 2.02(b)(5), *see also id.* §§8.51(a), 8.53, 8.58(a).

392 Del. Gen. Corp. L. § 145(b) permits indemnification "in respect of any claim . . . as to which such person shall have been adjudged to be liable to the corporation . . . only to the extent that the Court of Chancery . . . shall determine . . . in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity."

power granted to corporations to adopt charter provisions which eliminate the monetary liability of directors (but not officers, and not directors acting in the capacity of an officer).[393] If damages are awarded, presumably in a derivative suit, the plaintiffs will typically have no incentive to oppose a request by the company that the judge approve indemnification for expenses.

Almost all public companies have turned the "may" of Delaware law into "shall" by adopting bylaws that provide that the company *shall* advance expenses to and indemnify directors, officers and employees to the fullest extent permitted by Delaware law.[394] Thus directors will have their expenses covered if they act in good faith. Experience suggests that directors will usually be generous to their fellow directors in deciding whether conduct was in good faith, much as they will be generous in deciding whether the corporation should sue a director for breach of duty to the corporation.

Typically, a company provides in its bylaws, in agreement with individual directors and officers, or both, that it *will* indemnify directors to the maximum extent permitted by the corporate law. United States corporate law typically also required the corporation to indemnify a director or officer for legal expenses if the defense is successful.[395] However, customary bylaws providing for indemnification to the full extent permitted by law are broader than, and therefore supersede, legal rules that make indemnification mandatory in some cases.

Advancement of expenses

Corporations are permitted to advance legal expenses to directors and officers. Public corporations routinely commit to advance legal expenses through bylaw provisions and contracts with individual directors and officers. The courts have been generous in interpreting these provisions to protect directors and officers. For example, in one recent case, an officer who had pled guilty in a criminal case, but had not yet been sentenced, was held to be entitled to advancement of legal expenses until the date of sentencing, even though it was not disputed that the officer had no significant assets, and could not repay the advanced expenses once he had been sentenced.[396]

In theory, a firm could refuse to pay an outside director's expenses and force the director to sue to recover them. However, this seems unlikely in the real world absent clear bad faith conduct. Many suits are against most or all directors, so the directors will be voting to reimburse themselves. Even if not, directors will usually be sympathetic to a fellow director. One can imagine loyalty to fellow directors being less important if there has been a sudden turnover of the board, perhaps after a financial scandal. But even so, the company's current directors will likely vote to spend the shareholders' money to treat former directors as they would want to be treated themselves. Consistent with this

393 Delaware General Corporation Law § 102(b)(7).

394 These bylaws are expressly permitted by Delaware General Corporation Law § 145(f). See also Model Business Corporation Act § 8.58(a).

395 See Delaware General Corporation Law § 145(c); Model Business Corporation Act § 8.52.

396 *Bergonzi v. RiteAid Corp.*, 2003 Del. Ch. LEXIS 117.

analysis, there are occasional court battles between a company and an officer over indemnification, but none involving outside directors.[397]

The principal limit on indemnification and advancement of expenses is the requirement that conduct be in good faith. The additional requirement that the conduct be in or not opposed to the firm's interests does not affect this analysis. Good faith conduct will be arguably in or not opposed to the corporation's interests, and other directors will likely give their fellow director the benefit of any doubt. This is especially true given that: (i) the directors will be advised by counsel on their legal obligation to advance expenses and on the risk that a refusal to do so could be bad faith conduct that would expose the directors to (largely theoretical, to be sure) risk of liability; and (ii) if they refuse to advance expenses, they can expect to be sued themselves, and will likely lose the suit. The bottom line on advancing expenses to outside directors is simple: We know of no case where a solvent public company has not honored a bylaw requiring it to pay outside directors' legal expenses.

The Sarbanes-Oxley Act prohibits public companies from lending money to directors or officers. Although the matter is not entirely clear from doubt, this ban has generally been interpreted *not* to bar the advancement of legal expenses. (Compare the contrary interpretation in France of a similar ban on loans.)

Limits on indemnification

There are three scenarios in which indemnification might not protect outside directors against payment of damages, in a suit by third parties, where indemnification would ordinarily be available under the rules discussed above. First, and of greatest importance in practice, the corporation may be insolvent or insufficiently solvent to cover the outside directors' damages. Second, a director's conduct may fall outside the statutory qualification for indemnification quoted above. As the Delaware Chancery Court has defined the term in the recent *Disney* case, an absence of "good faith" comprises acts of self-dealing or an "intentional dereliction of duty, a conscious disregard for one's responsibilities."[398]

Third, in a case brought under section 11 of the Securities Act of 1933, SEC policy may preclude indemnification. The SEC has taken the position that any indemnification obligation to directors for damages paid in section 11 claims is "against public policy as expressed in the [Securities] Act and is therefore unenforceable."[399] The SEC enforces this policy by requiring a company seeking acceleration of the effective date of a registration statement to agree in advance that if a director seeks indemnification for damages, the company "will . . . submit to a court of appropriate jurisdiction the question whether such indemnification by [the company] is against public policy as expressed in

397 For an example of the former, see *Fasciana v. Electronic Data Systems Corp.*, 829 A.2nd 178 (Del. Ch. 2003).

398. *In re The Walt Disney Co. Derivative Litigation*, 907 A.2nd 693 Del. Ch. 2005), affirmed by the Delaware Supreme Court, 906 A.2nd.27 (2006).

399. Regulation S-K, 17 Code of Federal Regulations § 229.510 (2006).

the Act."[400] A company is under no such obligation, however, if the expenses were incurred in the course of a "successful defense."

However, almost all securities suits are settled, and settlements do not trigger these undertakings with the SEC since settlement agreements routinely recite the defendants' position that no wrongdoing occurred. We know of no cases in which outside directors have gone to trial in a section 11 case and been held liable for damages in the last 30 years. If an outside director were tried and held liable, a court might be called upon to rule on the validity of the SEC's policy and the extent to which indemnification in that particular case violated public policy. However, the company and the directors might be able to avoid the issue by having the company pay damages directly. If a company were to bring the question of indemnification to court, it is unclear what the outcome would be, especially in a case involving nothing worse than negligence.[401]

Summary and recommendations

Practice in the comparison countries with regard to compensation of directors and managers for damages and legal and other expenses, incurred in a civil suit or in a government proceeding, varies widely. Some common themes can be discerned however.

First, it is important to distinguish between compensation for damages, or for civil or criminal penalties, and compensation for legal and other expenses. Second, with regard to compensation for damages, it is important to distinguish between actions under company law, where the recovery will be paid to the company, and actions by third parties, where the recovery will be paid to the third party. Third, for legal and other expenses, it is important to distinguish between an ultimate right to compensation for these expenses, and the right to receive advancement of expenses, in order to permit an active defense, before the outcome is known.

Compensation for damages in a civil suit

With respect to compensation for damages in a civil suit, it is important to distinguish between compensation for liability to the company and compensation for liability to third parties, including liability to shareholders under securities law. The principal subject of this report is liability for breach of duty to the company under company law. None of the comparison countries provides for compensation to directors and officers for damages that they are obliged to pay to the company. We recommend that compensation should

400. Regulation S-K, 17 Code of Federal Regulations § 229.512(h)(3) (2006). In practice, all companies that register securities seek to accelerate the effective date of the registration.

401. In *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (Eastern District of New York, 1971), in which the company and three directors were held liable under section 11, the SEC treated the company's proposal to pay the entire judgment as a declaration of intent to indemnify the directors and challenged the proposal. The parties subsequently agreed that the three directors pay the company $5,000 each. The SEC did not challenge this arrangement, and the *Leasco* court found that the agreement did not violate public policy. *See* Joseph W. Bishop, Jr., *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws*, 1972 DUKE LAW JOURNAL 1153-1166, at pages 1161-64 (stating reasons why a court could find no inconsistency with public policy).

not be permitted in this situation. Compensation would not make sense in this context, it would imply that the plaintiff would be reimbursing the defendant, and would make the case pointless to bring in the first plase.

With respect to liability of a director or manager to third parties, a stronger case can be made that a company should be permitted to compensate a director or manager who is found liable or make a payment to settle a case, if the cause of liability involves negligence or perhaps gross negligence, without self-dealing. We recommend that companies be permitted to agree in advance, as part of the overall contract between the company and a director or manager, to compensate their directors and managers for amounts paid to third parties arising out of their official duties on behalf of the company, either in settlement or after a court decision, subject to the following constraints:

- the director or manager acted in good faith, or reasonably believed he was acting in good faith;
- the director or manager acted in the interests of the company, or reasonably believed he was acting in the interests of the company;
- there is no specific provision, in the statute providing for liability, that bars compensation by the company for this particular type of liability; and
- the compensation has been approved by a vote of non-interested shareholders (shareholders who are not themselves potential beneficiaries of the compensation provision). In the usual situation in which the company proposes to provide compensation generally to all directors, approval by non-interested shareholders will be required under the rules in JSC Law ch. 11 governing transactions in which an interest may exist.

The company would have the power either to enter into a contract providing for compensation to the extent permitted by the JSC Law or other federal laws, or to adopt a bylaw or charter provision providing for this compensation. The form of contract or the bylaw or charter provision would be subject to approval by non-interested shareholders at a general shareholder meeting. The contract, bylaw, or charter provision would normally be in place prior to a lawsuit.

We recommend that a company should also have the power to agree to compensate a director or manager, after a particular action has been brought, and also after the director or officer has agreed to make a damages payment, by a vote of the non-interested directors, followed by approval by non-interested shareholders. We understand that there is an issue of validity which arises for ex post compensation, because this compensation could be considered to be a gift to the director or manager. In our view, the agreement of the director or manager to provide future services can provide consideration for this compensation, sufficient so that the compensation will not be considered to be a gift and therefore invalid.

There remains the question of who decides whether a director or manager has acted in good faith and in the interests of the company. In our view, this decision should be made by a court at the request of the company, or of the director or manager. This will protect against the risk that the company's board of directors, which will often favor payment of compensation, will conclude that good faith was present when an objective observer would find that good faith was absent.

Compensation for administrative and criminal fines and penalties

A separate question from compensation for damages paid as a result of a civil suit is whether the company should be able to compensate directors and managers who become liable for administrative or criminal penalties. We believe that compensation against these penalties would undermine the purpose of the administrative or criminal sanctions, and hence should not be permitted.

Compensation for legal and other expenses

In our view, it is important for a company to have the power to compensate directors and managers against legal and other expenses, and to advance expenses to them, before the outcome of a case is known. Otherwise, a director or manager could be financially ruined by the expense of defending against a lawsuit, regardless of the outcome of the suit. The director or manager could also be forced to settle a case that could be won, simply because the cost of a vigorous defense exceeds the director's or manager's personal resources. The potential to recover some of one's expenses from the plaintiff if the defendant wins the case in court provides cold comfort, both because the recovery will be, at best, only partial and because of the risk that the director will not be able to mount a vigorous defense to begin with.

A good recent example of this scenario arises from the *Equitable Life* case in the U.K. Cheffins and Black describe this litigation as follows:[402]

> A catalyst for . . . concern was a lawsuit brought by Equitable Life, a major British insurer that nearly went bankrupt in the late 1990s. The old board was replaced after the debacle, and the new board sued the auditor and fifteen former directors, including nine non-executives, for damages exceeding £3 billion. The non-executive directors sought to have the claim against them dismissed, but this application failed. Equitable had D&O coverage of £5 million, which was insufficient to cover the directors' legal expenses, let alone potential damages. [The directors had to pursue arbitration proceedings against the insurer to even obtain access to this amount.] The trial began in 2005 but after the case went badly for Equitable it agreed to drop its claim and pay the legal expenses of the non-executive directors. Despite this outcome . . ., the litigation was often cited as the sort of nightmare that would make the boardrooms of public companies tougher to fill. . . .
>
> As the case was proceeding, a number of the ex-directors said that if they became liable to pay damages under a settlement or as a result of a trial, there would be nothing for the company to collect from them because their financial assets would have been swallowed up by legal expenses. [A couple of directors were forced to dismiss their counsel and proceed without legal representation, because they could no longer afford their legal bills.]

402 Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEXAS LAW REVIEW 1385-1480 (2006), at 1399-1400, 1406-1407.

In our view, the risk of a situation such as *Equitable Life* justifies strong rules entitling directors to both compensation for legal expenses, and advancement of these expenses. We address compensation first.

The *Mannesmann* criminal case, discussed below in Chapter 13, provides another relevant example of compensation in a civil law jurisdiction. Josef Ackermann, who was the chairman of the board of directors of Mannesmann, while also serving as the CEO of Deutsche Bank, was charged with breach of trust for proposing that a bonus be paid to Mannesmann CEO Klaus Esser following Mannesmann's agreement to be acquired by Vodafone. Mr. Ackermann later agreed to pay a €3.2 million fine out of his own pocket in return for the prosecution dropping criminal charges. He also incurred large legal expenses, estimated at $3 million, for which he was compensated by Deutsche Bank.[403] The legal basis for compensation, presumably, was the importance of Mr. Ackermann's services to Deutsche Bank.

One must also address what limits should there be on a company's power to compensate directors and managers for legal and other expenses. We recommend that companies should have the power to compensate directors for expenses in all types of cases, including cases brought in the name of the company, either by the company or through a derivative suit. We recommend that the company should also be able to compensate directors and managers for legal and other expenses in connection with an administrative or criminal proceeding, whether or not the director is successful in defending against the suit or proceeding. We recommend, however, that compensation for expenses should be available only if:

- the director or manager acted in good faith, or reasonably believed he was acting in good faith;
- the director or manager acted in the interests of the company, or reasonably believed he was acting in the interests of the company;
- there is no specific provision, in the statute providing for liability, that bars compensation for expenses for this particular type of liability; and
- the compensation has been approved by a vote of non-interested shareholders (shareholders who are not themselves potential beneficiaries of the indemnification provision).

The requirement of shareholder approval should provide sufficient assurance that it is in the company's interests to provide this protection. Based on U.S. experience with shareholder approval of charter provisions limiting the liability of outside directors, we are confident that shareholders would approve reasonable compensation agreements. We expect that most companies will obtain this approval in advance, in connection with compensation agreements between the company and all directors and senior managers, or a bylaw or charter provision. However, we would also allow this approval to be obtained after a suit has been commenced, in the same manner as discussed above for compensation for damages.

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403 See Mark Landler, *Six in Germany Settle Landmark Case on Bonuses*, NEW YORK TIMES, Nov. 25, 2006.

Indemnification for legal expenses in administrative and criminal proceedings

The question of whether a company should be able to compensate its directors and officers for legal expenses incurred in defending against administrative or criminal proceedings can be seen as distinct from the question of whether the company should be able to provide this compensation in a civil suit. We recommend that the company should be able to provide compensation against legal expenses in administrative and criminal proceedings, in the same manner as for private suits. A company should be able to provide comfort to a director or manager that the director or manager will have the power to vigorously defend against a government action that arises out of his official duties, regardless of his personal financial situation.

Thus for administrative and criminal proceedings, we would distinguish between fines and penalties, for which compensation would not be permitted, and legal expenses, for which indemnification would be permitted. This approach is consistent with the outcome in the Mannesmann case in Germany. This approach is also consistent with practice in the United States. While compensation against fines and penalties is often permitted under U.S. corporate law, a common outcome of an actual proceeding is a court order which specifies that the fine or penalty should be paid personally by the defendant, without reliance either on compensation by the company or on D&O insurance.

Advancement of legal expenses

An important question that is closely related to compensation for legal expenses is whether the company can advance legal expenses to a director or manager, before the outcome of a suit is known. The core new issue that this raises is the risk that the company will advance expenses to a director or manager, but it will later turn out that the director or manager is not entitled to compensation and lacks the financial capacity to repay the company.

The United States view is that a director or manager should be entitled to a presumption that this person is not liable, until proven otherwise, and therefore expenses should be advanced, regardless of the ultimate outcome. The Delaware courts have held that this entitlement exists even when there is strong reason to believe that the director or manager will not, in the end, be entitled to payment of expenses.

We recommend an intermediate position, which is more likely to accord with Russian views. We recommend that a company should be permitted to advance expenses, without regard to the director's or manager's ability to repay, provided that:

- the advancement of expenses has been approved by a vote of non-interested shareholders at a general shareholder meeting; and
- the director or manager signs an affidavit stating that he believes he will be entitled to compensation.

The necessary shareholder approval could again come in advance, through approval of a compensation agreement, bylaw, or charter provision, or after the suit has been commenced.

A court would have the power to review the affidavit, conclude based on all of the available facts that it is unlikely that the director or manager will be entitled to compensation of expenses, and on that basis rule that expenses should not be advanced. However, expenses would still be advanced until such a ruling was issued. This would ensure that the director's or manager's expenses are covered at least for long enough for the facts to be developed and for the director or manager to present an argument in favor of continued advancement of expenses.

In our judgment, the power of companies to advance expenses should extend to administrative and criminal proceedings. Indeed, this power is especially important in these proceedings, as a counterweight to government power. In the United States, for example, the Department of Justice several years ago adopted a policy discouraging companies, whose officers were under criminal investigation or trial, from paying these officers' legal expenses. The U.S. courts have sharply criticized this practice, with one court holding that the pressure put on companies not to advance expenses is a violation of the constitutional rights of the defendants.

Interaction between compensation by the company and D&O insurance

Protection against payment of legal expenses, including advancement of these expenses, is an important protection for directors and managers. This protection can be provided by the company, but it can also be provided by directors' and officers' (D&O) insurance (discussed in subchapter 9.2). However, D&O insurance is not a full substitute for compensation by the company, for several reasons.

First, not all companies will have the foresight to purchase this insurance, or to purchase insurance in amounts sufficient to protect the directors. Second, the directors may need protection against the risk that the insurer will refuse to pay, on one basis or another.

The *Equitable Life* case illustrates both of these risks. The directors were insured, but first had to fight with the insurer to obtain coverage at all, and then found that the policy limits were insufficient to cover their legal expenses.

A further risk with D&O insurance is that the insurer will go bankrupt. A number of U.S. directors found themselves in this situation when Reliance Insurance, a prominent D&O insurer, went bankrupt in the 1990s. Some of these directors ended up making payments for legal expenses, damages, or both, that would otherwise have been covered by D&O insurance. The directors in these cases were entitled to compensation by their companies, but their companies had also gone bankrupt. Directors of solvent companies, who were insured by the same bankrupt insurance company, would have faced similar risk, were it not for the availability under U.S. law of compensation from the company.

Subchapter 9.2. Insurance of liability of members of management organs

Issue: What should be the terms of standard (or minimum) directors and managers liability insurance? What limits should there be on a company's authority to purchase directors' and officers' liability insurance to cover directors and senior managers against legal expenses, damages, and civil or criminal penalties, or on the terms of the insurance it is permitted to purchase?

Russian context

At present, the concept of liability insurance for members of management organs is in a stage of active development. Up to now the legal bases essential for this insurance have not been created. However, a number of companies are providing this insurance to the members of their management organs, in spite of its uncertain legal status.

The primary laws regulating insurance in the Russian Federation are the Civil Code and Federal Law No. 4015-1 "On the Organization of the Insurance Business" (hereafter -- Insurance Law), dated 27 November 1992. Neither of these sources of legislation, however, directly establishes liability insurance for the members of management organs of legal entities as a particular type of insurance that is defined, permitted, and regulated. Among the types of insurance that are currently defined, the following are most similar to this insurance: (a) civil liability insurance for causing harm to third parties and (b) civil liability insurance for improper fulfillment or failure to fulfill one's contractual obligations. At present it is unclear whether liability insurance for members of management organs falls into one of the indicated types, should be considered to be a mixed type, or should be considered to be a separate type of insurance altogether.

Under Civil Code art. 931, under a contract of insurance for causing harm, only the risk of liability arising as the result of causing harm to the life, health, or property of other persons can be insured. The liability of members of management organs, however, arises not from a tort but from their improper fulfillment of their duties with respect to the company. Consequently, it is unclear whether liability for improper fulfillment of duties can be insured under this type of insurance contract.

The second type of insurance (for failure to fulfill one's contractual obligations), in the given instance, also cannot be used because, under Civil Code art. 932, this type of insurance is possible only in cases provided for by law. The JSC Law does not provide for this possibility.

In practice, Russian insurance companies insure the liability of members of management organs by treating it as the first type of insurance -- they rely on their license to provide civil liability insurance for causing harm to third persons. Bodies for insurance oversight have thus far not objected to the issuance of this form of insurance, but there are no judicial decisions on whether the insurance is valid.

Conclusion: The law should be amended to create a clear legal basis for liability insurance for the members of management organs.

Canada

While nearly all Canadian public companies purchase D&O insurance, Canadian corporate legislation does not impose any obligation on companies to purchase coverage for director liability. There are also no statutory rules governing minimum or standard terms. Lawmakers are content to let market forces govern.

The CBCA explicitly permits companies to purchase D&O insurance to cover both damages and legal expenses (CBCA § 124(6)). Provincial corporate legislation does likewise but also generally precludes D&O coverage for breaches of duty where directors have failed to act honestly and in the company's best interests (e.g. OBCA § 136(4)). The CBCA was amended in 2001 to remove this restriction. This change to the CBCA is unlikely to matter much in practice because standard D&O policy language already excludes coverage where a director has been dishonest or has obtained a personal profit.

France

Since French law does not require D&O insurance, there are also no minimum requirements stipulated by law. In fact, the great diversity of business associations provides a good argument against the legal harmonisation of terms.[404] Directors' and officers' insurance is still a relatively new phenomenon in France. However almost 94% of large firms have such insurance.[405]

French insurance law specifically permits D&O insurance contracts, but also imposes some restrictions on the terms of insurance.[406] Under Insurance Code (Code des Assurances) art. L. 113-1, the insurer is permitted to cover only damages resulting from negligent conduct, but not from intentional wrongdoing.[407] This provision is considered mandatory law.[408] Furthermore, the insurer may only pay a person who suffered damage, from which a causal link to the insured person's actions can be established.[409] Insurance contracts are not separately addressed in the French Civil Code.

None of these issues is subject to explicit statutory regulation under French corporate law. Thus, insurance law determines the extent to which D&O insurance can cover directors' liability. However, some general provisions of corporate law may be relevant. Under Code de Commerce art. L. 225-38, any contract entered into by the company with the CEO, an assistant general manager, a member of the board or a shareholder holding

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404 Joël Monnet, *Assurance de responsabilité. – Dirigeants sociaux,* JURISCLASSEUR SOCIETES TRAITE, Fasc. 132-15, ¶ 36 (Août 2003).

405 Joël Monnet, *Assurance de responsabilité. – Dirigeants sociaux, JURISCLASSEUR SOCIETES TRAITE*, Fasc. 132-15, ¶ 13 (Août 2003).

406 In France, D&O insurance is a form of "assurance de responsabilité" (Code des assurances, Arts. L. 124-1 et seq.). The French Civil Code does not specifically regulate insurance contracts.

407 *Compare* DEEN GIBIRILA, LE DIRIGEANT DE SOCIETE ¶ 255 (1995).

408 Joël Monnet, *Assurance de responsabilité. – Dirigeants sociaux,* JURISCLASSEUR SOCIETES TRAITE, Fasc. 132-15, ¶ 30 (Août 2003).

409 Code des Assurances article 124-1, 124-3. *See* Joël Monnet, *Assurance de responsabilité. – Dirigeants sociaux,* JURISCLASSEUR SOCIETES TRAITE, Fasc. 132-15, ¶ 28 (Août 2003).

more than 10% of votes, requires prior approval by the board of directors. The same applies to contracts where such a person has an indirect interest. However, since the insurance contract is not entered into by the director, and as the benefit of insurance can be considered to have the character of remuneration (which is normally not considered to by subject to that provision), it is unclear whether Article L. 225-38 applies.[410] Still, it would be recommended practice for companies to ensure that the terms of their D&O insurance are approved by the board of directors.

Generally, Code de Commerce art. L. 241-3 provides criminal penalties in the case of *abus de biens sociaux* (abuse of the corporate patrimony) for directors who use corporate funds for their own benefit to the detriment of the corporation (see also the discussion of criminal penalties in Chapter 13). However, it can be argued that entering into an insurance contract, which ultimately ensures the payment of damages to the company, should not be seen as counter to its interest and therefore should not violate this provision.[411] The same argument applies to lawsuits brought on behalf of creditors in bankruptcy, as it can be said that providing insurance which potentially benefits the firm's creditors will also be in the company's interest, when it is seeking to borrow funds. However, this argument is more doubtful with respect to insurance covering criminal prosecution (with respect to which the law is also unclear), which is why Joël Monnet recommends that insurance contracts should require reimbursement by the director to the insurer if a criminal prosecution results in a conviction.[412]

Germany

There is no requirement for a company to buy D&O insurance and no minimum legislative requirements for the terms of such insurance. In Germany, as in France, insurance is regulated by a specialized law on insurance (VVG). Under this law, D&O insurance is considered to be a form of liability insurance ("*Haftpflichtversicherung*"; see VVG § 149). Contracts on insurance are not separately addressed in the German Civil Code. In 1997 the German Insurance Association (GDV)[413] drafted standard terms for D&O insurance. However, the terms which are used in practice are said to be very diverse.[414]

A few years ago it was still argued that D&O insurance was contrary to the mandatory nature of the provisions on liability and remuneration of the joint stock company law.

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410 *See* TERRE ET AL., LE DIREGEANT DE SOCIETE: RISQUES AND RESPONSABILITES ¶ 008-06 (2002) (suggesting that the provision is applicable); Monnet *idem* at no 22 (arguing against applicability).

411 Charles Freyria, *L'assurance de responsabilité civile du »management«*, 1995 RECUEIL DALLOZ SIREY, CHRONIQUE 120, at 121-122; Joël Monnet, *Assurance de responsabilité. – Dirigeants sociaux,* JURISCLASSEUR SOCIETES TRAITE, Fasc. 132-15, ¶ 24 (Août 2003).

412 Joël Monnet, *Assurance de responsabilité. – Dirigeants sociaux,* JURISCLASSEUR SOCIETES TRAITE, Fasc. 132-15, ¶ 26 (Août 2003).

413 The English version of the GDV website is at http://www.gdv.de/Hauptframe/index.jsp?navi=english.

414 See Michael Vothknecht, Die „wissentliche Pflichtverletzung" in DER VERMÖGENSSCHADEN-HAFTPFLICHT-/D&O-VERSICHERUNG, PHi 2/2006, 52-63, at http://www.genre.com/shared-file/pdf/PHi20062_Pflichtverletzung-de.pdf.

Currently, it is the unanimous view of commentators that in general D&O insurance for board members is permissible.[415] Insurance for officers who are not members of the management board would also be possible, but this insurance is usually not necessary because officers are regarded as employees and thus are protected by labor law against liability, and because the duties to the corporation established by AktG § 93 do not apply to these persons.

D&O insurance for members of the management board is often included in the service contract entered into between the company and members of the management board. This contract is approved by the supervisory board (AktG § 112). For members of the supervisory board, some commentators hold the view that the purchase of this insurance must be approved by a general shareholder meeting or else must be authorized in the charter.[416] Others regard the decision to purchase this insurance as a matter of ordinary business management, in which case the management board must approve the purchase of D&O insurance for members of the supervisory board.[417] If this approach is followed, both boards have a mutual interest in obtaining insurance, so approval is, as a practical matter, not difficult to obtain.

Implicitly, D&O insurance is also accepted by the German Corporate Governance Code, which states, in § 3.8:

> "If the company takes out a D&O (directors' and officers' liability insurance) policy for the Management Board and Supervisory Board, a suitable deductible shall be agreed."

Although the German Corporate Governance Code is non-binding, some have relied on this provision to argue that, as a policy matter, if insurance is paid or bought by the company,[418] the insurance contract should provide for a deductible, so that the directors have some residual amount of personal monetary liability.[419]

As for the scope of this insurance, it is common for severe misconduct not to be covered. For fraudulent behaviour, non-coverage is required by insurance law.[420] Apart from that,

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415 See, for example, UWE HÜFFER, AKTIENGESETZ § 84, ¶ 16, § 113, ¶ 2a (7th edition 2006); Klaus Hopt, in GROßKOMMENTAR ZUM AKTIENGESETZ § 93, ¶ 520 (4th edition, 1999); Wolfgang Hefermehl & Gerald Spindler, in 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 93, ¶ 93 (Bruno Kropff & Johannes Semler editors, 2nd edition, 2004).

416 UWE HÜFFER, AKTIENGESETZ § 113 ¶ 2a (7th edition 2006); Kästner, *AG* 2000, 113, 118.

417 Johannes Semler in 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 116, ¶ 777 (Bruno Kropff & Johannes Semler editors, 2nd edition, 2004); Klaus Hopt, in GROßKOMMENTAR ZUM AKTIENGESETZ § 93, ¶ 519 (4th edition, 1999); Hans-Joachim Mertens, *Bedarf der Abschluss der D&O-Versicherung durch die AG der Zustimmung der HV?*, 2000 DIE AKTIENGESELLSCHAFT 447, at 451; Meinrad Dreher, *Der Abschluss von D&O-Versicherungen und die aktienrechtliche Zuständigkeitsordnung*, 165 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT 293 (2001), at 313, 315.

418 In general, this type of insurance for the account of a third party is possible. See Law on Insurance Contracts (VVG) § 74.

419 Wolfgang Hefermehl & Gerald Spindler, in 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 93, ¶ 94 (Bruno Kropff & Johannes Semler editors, 2nd edition, 2004).

420 Law on Insurance Contracts (VVG) § 152.

these limits can be based on the general principle that the management organs of the company must act in the interest of the company and its stakeholders. If directors were completely insulated against liability, this principle would be violated. However, since the purchase of D&O insurance also has benefits for the company and for its stakeholders,[421] the company's management organs have relatively wide discretion to determine what scope of coverage to purchase. There is also not yet any case law on the permitted scope of coverage, or on the need for a deductible of some sort.

Korea

The Korean market for D&O insurance is quite new. The first known shareholder lawsuits were brought in 1997 against Korea First Bank and in 1998 against Samsung Electronics.[422] Not coincidentally, the Korean D&O insurance market took off at the same time. Insurance is considered especially important since there is doubt about the validity of agreements by companies to indemnify directors against liability (see subchapter 9.1). Directors can obtain director's liability insurances from a number of Korean insurance companies against certain civil (but not criminal) liabilities. Coverage provided by director's liability insurance usually includes damages resulting from such wrongful acts of directors (as well as legal fees resulting thereof) but generally will not include damages resulting from a director's pursuit of illegal personal profit, willful misconduct or compensation claimed by major shareholders of the company. It has recently been reported that about 34.4 percent of all public companies purchased a D&O policy as of December 2004.

Neither the KCC nor any other laws provide minimum standards for D&O insurance, nor specifically address whether this insurance is permitted. In practice, however, a majority of larger public companies now have this insurance, and standard insurance policy forms are used. The forms are created by the General Insurance Association of Korea and approved by the Korea Financial Supervisory Service. However, there is no express legal requirement that this form must be used.

Insurance policies used in Korea do not cover liabilities due to intentional misconduct or gross negligence. The Korean tax authority used to levy income tax on the insurance premium (that is, the expense could not be treated as a business expense and deducted from income), but changed the rule to provide an exemption. However, an insurance policy that covers intentional acts and gross negligence will be subject to the taxation.

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421 In particular, D&O insurance can protect the company against the insolvency of the directors; see Johannes Semler, in 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 116 ¶ 775 (Bruno Kropff & Johannes Semler editors, 2nd edition, 2004); Klaus Hopt, in GROßKOMMENTAR ZUM AKTIENGESETZ § 93, ¶ 519 (4th edition, 1999); Kurt Kiethe, *Persönliche Haftung von Organen der AG und der GmbH - Risikovermeidung durch D&O-Versicherung?*, 2003 BETRIEBS-BERATER 537, at 539; Jobst-Hubertus Bauer &Jerome Krets, *Gesellschaftsrechtliche Sonderregeln bei der Beendigung von Vorstands- und Geschäftsführerverträgen*, 2003 DER BETRIEB 811, at 814.

422 See Hwa-Jin Kim & Daniel Yi, *Directors' Liabilities and the Business Judgment Rule in Korea* (working paper 2004), at http://ssrn.com/abstract=530442.

United Kingdom

Britain is the largest European market for D&O insurance. However, U.K. corporate legislation does not directly address the terms of D&O insurance, nor does it expressly permit or restrict companies from purchasing this insurance. There are also no statutory rules governing minimum or standard terms. Instead, lawmakers have been content to let market forces govern the terms on which this insurance is available.

D&O policies, however, inevitably exclude coverage for dishonest or fraudulent conduct and for the obtaining of a private benefit or profit. English courts will also decline to enforce terms of insurance policies that contravene the interests of public policy, which may well mean that, regardless of how D&O insurance is structured, knowing or intentional director misconduct is uninsurable.

United States

U.S. corporate law does not require companies to buy D&O insurance. The laws of most states do not specify any minimum or mandatory terms for this insurance. However, New York law requires a minimum deductible of up to $5,000 per incident, so that a director or officer who is liable for damages must, in principle, pay the first $5,000 of any damages award. It is unclear whether even this modest deductible is enforced in practice, because a director could refuse to settle at all, thus imposing large legal costs on the insurer, unless the insurer agrees to waive the deductible.

Virtually all public companies purchase D&O insurance for their officers and directors.[423] D&O insurance covers directors' legal expenses, damages paid pursuant to judgment, and amounts paid in settlement. In contrast to indemnification, neither corporate law[424] nor securities law[425] places limitations on the permissible scope of D&O coverage.[426]

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423. *See* TILLINGHAST-TOWERS PERRIN, UNDERSTANDING THE UNEXPECTED: 2004 DIRECTORS AND OFFICERS SURVEY REPORT 25 (2004) (reporting that 100% of publicly held U.S. firms responding to survey had D&O insurance), *at* http://www.towersperrin.com/tillinghast/publications/reports/2004_D_O/2004_DO_Exec_Sum.pdf. Insurers sell and companies routinely buy policies without copayments or meaningful deductibles for covered individuals. When policies have copayments or deductibles, the company's indemnification obligation covers those payments in most cases. *See id.* at 46 (reporting that ninety-eight percent of surveyed firms purchase insurance with no deductible for personal coverage); JOHN F. OLSON & JOSIAH O. HATCH, III, DIRECTOR AND OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE § 12.20 (2003) (most companies buy insurance with no deductibles or copayments and that the exceptions are almost exclusively New York corporations, which must comply with a state insurance rule that requires a minimum deductible ranging from $100 to $5000).

424. Section 145(g) of the Delaware General Corporation Law gives a corporation the power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation . . . against any liability asserted against such person . . . in any such capacity . . . whether or not the corporation would have the power to indemnify such person against such liability . . . . S*ee also* Model Business Corporation Act § 8.57 (2004).

425. The SEC does not oppose insurance coverage for outside directors. *See* Securities Act Rule 461(c), 17 C.F.R. § 230.461(c) (2006). On the potentially anomalous nature of the SEC's distinction between indemnification, which it considers as against public policy for claims under the Securities Act of 1933 (see the discussion of this issue in subchapter 9.1) and its favorable views on insurance, see Joseph W. Bishop,

D&O policies contain exclusions from coverage. The most important of these are conduct exclusions, which bar claims for suits based on "criminal or deliberately fraudulent misconduct" and suits based on transactions resulting in an individual receiving "any personal profit or advantage to which he is not legally entitled."[427] Under many policies, the "deliberate fraud" exclusion applies only if there is a "final adjudication" of the issue in the underlying securities suit, which means the insurer cannot contest coverage on the basis of this exclusion if the case is settled. The "illegal profit" exclusion is often structured similarly, but it sometimes allows the insurer to contest coverage in a separate action.[428] Taken together, the deliberate fraud and personal profit exclusions are narrower than the good faith limitation on indemnification since the exclusions contemplate some form of actual dishonesty, whereas the good faith standard will be breached if there has been a "conscious disregard for one's responsibilities."[429]

Jr., *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws*, 1972 DUKE LAW JOURNAL 1153-1166, at 1161-1164 (explaining why a court could find that use of insurance to cover claims under the securities laws is consistent with public policy).

426. Under common law, courts will not permit recovery under insurance policies when the result would contravene public policy. For instance, in *Level 3 Communications Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001), and *Conseco Inc. v. National Union Fire Insurance Co.*, No. 49D130202CP000348, 2002 WL. 31961447 (Ind. Cir. Ct. Dec. 31, 2002), the courts held that it was contrary to public policy for an insurer to reimburse a company for settlement payments attributable to a section 11 breach. The rationale for the rulings was that it is inappropriate for a company to obtain via insurance restitution of the ill-gotten gains it received from a fraudulent securities offering. The decisions have led to some speculation that directors may not be able to rely on D&O insurance for coverage of section 11 claims. The public policy rationale does not go so far, however, except perhaps where the outside directors have enriched themselves in a fraudulent offering, in which case the policy exclusions would apply to the extent a damage payment constitutes restitution of amounts the outside directors gained as a result of the fraudulent offering. *See* Joseph P. Monteleone, *Directors' and Officers' Liability and Insurance: The Emerging Hot Issues in 2003*, THE RISK REPORT, May 2003, *at* http://www.eagle-law.com/papers/newyork2003_en-04.pdf. For a somewhat broader reading of the restrictions imposed by public policy, see James Denison, *Anticipated Coverage Issues Arising from Securities Actions Seeking Return of Ill-Gotten Gains*, 33 SECURITIES REGULATION LAW JOURNAL 162-170 (2005), at 167-168.

427. These exclusions are commonly referred to as the deliberate fraud and illegal profits exclusions. *See* 2 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 25.03 (7th edition, 2005); JOHN R. MATHIAS, JR., TIMOTHY W. BURNS, MATTHEW M. NEUMEIER & JERRY J. BURGDOERFER, DIRECTORS AND OFFICERS LIABILITY: PREVENTION, INSURANCE AND INDEMNIFICATION §§ 8.04, 8.14 (2003); JOHN F. OLSON & JOSIAH O. HATCH, III, DIRECTOR AND OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE § 12.12 (2003).

428. 2 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 25.03 (7th edition, 2005); JOHN R. MATHIAS, JR., TIMOTHY W. BURNS, MATTHEW M. NEUMEIER & JERRY J. BURGDOERFER, DIRECTORS AND OFFICERS LIABILITY: PREVENTION, INSURANCE AND INDEMNIFICATION § 8.04 (2003); JOHN F. OLSON & JOSIAH O. HATCH, III, DIRECTOR AND OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE § 12.12 (2003); *see also* Model Business Corporation Act, comment to § 8.57 (2002) (noting that D&O policies "typically do not cover . . . dishonesty, self-dealing, bad faith, knowing violations of [law], or other willful misconduct").

429. *In re The Walt Disney Co. Derivative Litigation*, 907 A.2nd 693, 755 (Del. Ch. 2005), affirmed by the Delaware Supreme Court, 906 A.2nd.27 (2006).

Summary and recommendations

D&O insurance for damages in a civil suit

The comparative discussion suggests that even countries which restrict the ability of companies to compensate directors for damages paid in a civil suit generally allow companies to purchase D&O insurance, which will protect directors against personal liability for legal expenses in any kind of proceeding, as well as for damages in a civil suit. We believe that both insurance and indemnification are important. We recommend that insurance should be permitted, *especially* if there are important restrictions on a company's power to compensate its directors and managers against risks, either for damages or legal expenses, arising out of performance of their official duties.

More specifically, we recommend that a company be permitted to purchase D&O insurance for its directors and managers, provided that the amount, principal terms, and cost of the insurance are disclosed to shareholders and approved by non-interested shareholders at a general shareholder meeting. Damages in a civil suit should generally be insurable. However, insurance should not be permitted for:

- damages that result from actions by a director or manager that produced, directly or indirectly, a personal financial benefit;
- damages that result from an intentional violation of law by the director or manager;
- administrative or criminal fines and penalties; or
- other instances in which there is a specific provision, in the statute providing for liability, that bars insurance against damages for this particular type of liability.

As a practical matter, experience in other countries indicates that insurers will not agree to provide coverage against liability when a director has intentionally violated the law or obtained a personal financial benefit in any case. Practice varies with regard to whether administrative and criminal fines are insurable.

D&O insurance for legal and other expenses

A separate question is what limits, if any, there should be on whether a D&O policy can cover legal expenses. We recommend that such coverage should be permitted in all cases, including administrative and criminal proceedings. Indeed, the case for permitting insurance is especially powerful in this case, because it provides a counterweight to the power of the government.

We believe that it is appropriate for a company, through the purchase of insurance, to make it possible for its directors and managers to defend themselves fully in an action by the government seeking administrative or criminal sanctions. Experience teaches that without such insurance, the cost of defending a lawsuit often exceeds the financial resources available to most directors and managers.

Russian Civil Code: Restrictions on types of insurance

We understand that at present, some Russian companies have purchased D&O insurance, usually from U.K.-based insurers. However, there are legal doubts about the enforceability of this insurance because it does not easily fit into one of the standard types of insurance provided for in the Civil Code and the Russian Law on Insurance.

The Russian Civil Code contains detailed provisions on permitted types of insurance. This is in contrast to the French and German codes, which are silent on the subject of insurance contracts, and leave these contracts to be regulated by specific laws on insurance. Of the principal types of insurance contemplated by the Russian Civil Code, D&O insurance is most similar to insurance for violation of a contract, because of the contractual nature of the relationship between a director or manager and a company. However, under Russian Civil Code art. 932, under this type of insurance, only the insured's own liability may be insured against. An insurance contract which does not meet this requirement is considered void. If this provision is interpreted literally, a company could be permitted to purchase insurance against its own liability, but not against the liability incurred by directors and managers. It is also possible that directors and managers could be covered for damages but not for legal expenses and other costs of defending against a claim (which are not the "liability" itself). There are as yet no court decisions on these issues. Problems might also arise for an insurance contract under which the insurance company undertook to defend the insured director, or to advance expenses to a director before the liability case is resolved.

A further problem is that a standard D&O policy covers directors and managers against liability risks that are partly contractual and partly tort in nature, and also covers them against administrative risks, such as the risk of liability under securities law, and the legal expenses resulting from an administrative or criminal action. This type of mixed insurance is permitted under Civil Code art. 929(2), as a form of property insurance which includes insurance against other types of harm.

We recommend that the JSC Law be amended to specifically permit D&O insurance, against both damages and legal expenses, including advancement of legal expenses. We further recommend that Civil Code art. 932(2) be amended to specify that insurance under a contract can be purchased for the benefit of another person who has contractual relations with the insured. This will make Civil Code 932(2) similar to Civil Code 931(1), which permits the purchase of insurance for liability from causing harm to be purchased for the benefit of another person. We see no policy reason why Civil Code art. 932 is more restrictive, in this regard, than Civil Code art. 931.

Chapter 10. Particularities of liability of members of management organs of nonpublic companies.

Issue: What differences should there be in the fiduciary duties and liability under company law of the members of the management organs of nonpublic companies (limited liability companies and closed joint stock companies), compared to public companies?

Russian context

Russian legislation does not define the concept of a "public" company. None of the organizational and legal forms corresponds fully to the features of a public company. Although only an open company can issue shares to a wide group of people and thus become publicly traded, there is no requirement that an open company be a public company because these companies may not have publicly-circulating shares. Those open companies that have been listed on a stock exchanges and whose shares have actually been offered for acquisition to an unspecified group of persons can be called "public," as this concept is used in other countries.

Draft legislation would specify the following features of a public company, any of which would be sufficient for recognizing an open company as a public company:

- the company has placed its shares among an unspecified group of persons at least once;
- the shares of the company circulate among an unspecified group of persons on the secondary market as a result of actions of the company, its shareholders, or other persons (including financial intermediaries) acting on behalf and in the interests of the company or its shareholders;
- the company's public status is specified in its charter.

At times, the JSC Law differentiates between companies which have publicly issued shares from companies which have not. In particular, JSC Law art. 92(2) requires disclosure of additional information by open companies which have carried out a public placement of securities.

In most respects, the JSC Law regulates open and closed companies similarly. This includes the liability of members of management organs for wrongful actions in carrying out their duties. The table below provides an overview of the primary differences between open and closed companies.

Comparison of the Rules Regulating Open and Closed Companies

Criteria	**Open Companies**	**Closed Companies**	**Source**
Number of founders	Unlimited	Maximum of 50	JSC Law art. 10(2(1))
Number of shareholders	Unlimited	Maximum of 50	Civil Code art. 97(2(3)), JSC Law art. 7(3(2)) and 7(2(2))
Distribution of shares by the company	Open and closed subscription allowed; charter can limit closed subscriptions	The company cannot carry out open subscription or in another way offer its shares to an unspecified group of persons	Civil Code arts. 97(1.1), 97(2.1); JSC Law arts. 7(2.1), 7(3.1), 39(1-2)
Minimum charter capital	1,000 times the minimal monthly wage on the date of state registration	100 times the minimal monthly wage on the date of state registration	JSC Law art. 26
Preemptive rights to buy shares sold by other shareholders	Establishing preemptive rights for sales of shares by other shareholders is not possible	Shareholders have preemptive rights; the Charter can also grant such rights to the company	Civil Code art. 97(2.2), JSC Law arts. 7(2.3), 7(3.4).
Preemptive rights to buy shares sold by company	Shareholders have preemptive rights for shares sold through an open subscription	No existing norm	JSC Law art. 40(1)
Limits on the transfer of shares by shareholders	Consent of other shareholders is not required	Preemptive rights of other shareholders	Civil Code art. 97(1.1), JSC Law art. 7(2.1)
Company's publication of information	A company should annually publish its report, accounting balance sheet, profit and loss report, information about the date, time and place of the general shareholder meeting, and a list of affiliates and their shareholdings	Not required unless the company issues bonds or other securities for the public	Civil Code art. 91(2), JSC Law art. 92

In most cases connected with the liability of members of management organs, the provisions of the Law on Limited Liability Companies are similar to those in the JSC Law. The provisions of the Civil Code concerning this liability are also similar. The principal differences include the following:

(1) Any participant of a limited liability company, can file a claim against the members of the company's management organs, whereas the JSC Law limits this right to shareholders possessing in the aggregate at least 1% of the company's common shares.

(2) Under JSC Law art. 84(2), if, the rules for completion of a self-interested transaction are violated and, as a result, the company incurred losses, the self-interested person (who can be a member of the company's management organs) is liable to the company for these losses. The liability of several persons is joint. No analogous rule exist for limited liability companies.

(3) The JSC Law stipulates that State representatives on a company's board of directors bear the same liability as other members of the board of directors. No analogous provision exists for limited liability companies. In addition, under Law on Limited Liability Companies art. 7(2), the State can be a participant in a limited liability company only in cases specifically provided for by law.

Canada

Canada lacks separate corporate legislation for smaller or privately held companies. Thus, it lacks the distinction, present in Russia and some other countries, between joint stock companies and limited liability companies. Therefore, in general, the fiduciary duties and liabilities of directors are similar in public and private companies.[430]

The oppression remedy, while it is available to complainants in all corporations, operates differently in practice depending on the type of company involved. Only a small minority of proceedings brought under the oppression remedy involve publicly quoted companies and the success rate is lower in cases involving such firms.[431] A key reason is that the "equitable rights" that often underlie a successful oppression claim are less likely to arise in a publicly quoted company than they are in a private company. Perhaps the self-dealing which underlies most such claims is less egregious or less common in public companies as well.

France

The simplified joint-stock company (*Société par Actions Simplifiée, SAS*) is a company, which does not have to follow all provisions applicable to ordinary joint-stock companies. In particular, the governance structure is simplified. For example, the provisions on conflict of interest transactions (see discussion in Chapter 1 above) do not apply (Code de Commerce art. L. 227-1). However, with respect to directors' liability

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430 In some circumstances, corporate statutes exempt smaller companies from complying with otherwise mandatory requirements. For instance, under the CBCA companies that have not distributed shares to the public do not have to send proxy forms to shareholders before shareholder meetings (§ 149), do not have to appoint an auditor (§ 163) and do not have to create an audit committee (§ 171). These exemptions do not affect the provisions governing the liability of directors and officers.

431 Stephanie Ben-Ishai & Poonam Puri, *The Canadian Oppression Remedy Judicially Considered: 1995-2001*, 30 QUEEN'S LAW JOURNAL 79 (2004), at 92.

and derivative suits there is no deviation from the law of ordinary joint-stock companies (Code de Commerce, art. L. 227-1, 227-8).

With respect to the limited liability company (*Société à responsabilité limité, SARL*), the governance structure is also simpler than that of joint stock companies, because there are only shareholders and the managers, without a board of directors (Code de Commerce art. L. 223-18). Thus, the checks and balances of the law of joint stock companies do not work in the same way. However, with respect to liability to shareholders, the duties of managers are very similar to the duties of the CEO and the members of the board of directors of a joint stock company:

> Article L. 223-22: Managers shall be jointly or severally liable, according to the circumstances, to the company or to third parties for breaches of the legislative or regulatory provisions applicable to limited liability companies, for breaches of the memorandum and articles of association, and for their errors of management. Should more than one manager have cooperated in the same circumstances, the court shall determine the contributory share of each in the reparations. In addition to proceedings for reparation of prejudice suffered personally, the members may instigate civil liability proceedings against the managers, either individually or as a group subject to the conditions laid down by Conseil d'Etat decree. The plaintiffs shall be authorised to pursue reparation for the entirety of the prejudice suffered by the company to which, if applicable, damages may be granted. Any clause in the charter having the effect of subordinating the exercise of civil proceedings to prior notice to or authorisation of the shareholders' meeting, or which contains a waiver of the exercise of these proceedings shall be deemed null and void. No decision by the shareholders' meeting may have the effect of extinguishing civil liability proceedings against the managers for errors committed in the performance of their office.
>
> Article L. 223-23: The liability proceedings specified in Articles L. 223-19 and L. 223-22 shall be time-barred after three years with effect from the prejudicial act or, if it has been dissembled, from its disclosure. However, proceedings shall be time-barred after ten years if the act is classified as criminal.

Germany, Austria, and Latvia

Germany and Austria have separate statutes governing limited liability companies (*GmbHs*). These laws have a simpler structure and less mandatory law. For example, in Germany, a supervisory board is not mandatory (GmbHG § 52 I). Managers (*Geschäftsführer*) have to exercise the diligence of an orderly manager (GmbHG § 43 I) and may be subject to joint and several liability if they violate this duty (GmbHG § 43 II).

Generally, much what was said in previous sections about German joint stock companies also applies to German limited liability companies. However, the German law on limited liability companies does not explicitly provide for a derivative suit procedure. It is not clear whether one is available, and there is some scholarly debate on the issue.[432]

***Austria*.**

The Austrian GmbHG (which differs much more from its German counterpart than the Austrian law on joint stock companies differs from its German counterpart), requires a limited liability company with a large number of shareholders or employees to have a supervisory board (Austrian GmbHG § 29). The Austrian GmbHG also allows a derivative suit to be brought by a minority representing at least 10% or €700.000 of the firm's stated capital (Austrian GmbHG § 48 I). The lawsuit is controlled by plaintiff shareholders themselves, without a judicial admission procedure (as under the current German AktG), and without involvement by a special representative acting on behalf of the minority (as under the German AktG before 2005 and the current Austrian AktG).

Latvia

The Latvian law on limited liability companies is generally similar to the Austrian approach. The Latvian Commercial Code contains some provisions which are applicable to both joint-stock companies and limited liability companies. These include the provisions on derivative suits (Commercial Code, § 172). Thus, the same rules apply to limited liability companies and joint stock companies.

Korea

Korea has the limited liability company, which is analogous to the limited liability company in German law (GmbH) and the similar form of legal entity in Russian limited law. Limited liability companies are regulated not by a separate law but by a separate chapter in the KCC. KCC art. 567 contains the liability provisions for directors of a limited liability company. It simply refers to the liability provisions for directors of a joint stock company. Therefore, the same rules apply to the directors of both types of companies. As the limited liability company is not widely used in Korea, not many cases and commentaries are available.

United Kingdom

The UK does not have, and never has had, separate corporate legislation for smaller or privately held companies. In some circumstances, companies legislation exempt smaller companies from complying with otherwise mandatory requirements. For instance, under the Companies Act 1985, smaller companies are subject to less strict onerous accounting, audit and reporting requirements. Generally, however, the same statutory provisions apply to all companies.

The unfair prejudice remedy (Companies Act 1985, §§. 459-461, replaced by Companies Act 2006, §§ 994-999), discussed in earlier chapters, while it is technically available with respect to both public and non-public companies, operates differently in practice

432 See, for example, Holger Altmeppen, in GESETZ BETREFFEND DIE GESELLSCHAFTEN MIT BESCHRÄNKTER HAFTUNG § 43, ¶ 66 (Günther H. Roth & Holger Altmeppen editors, 5th edition, 2005).

depending on the type of company involved. The vast majority of proceedings brought under the unfair prejudice remedy involve nonpublic companies, and when a case is brought involving a public company, the success rate is low.[433]

One reason why the unfair prejudice remedy is of much less practical importance in publicly quoted companies is that the “equitable rights” that often underlie a successful unfair prejudice claim (such as a shareholder's expectation of being able to participate in management) are less likely to arise in a publicly quoted company than they are in a private company. Indeed, the courts are hostile to the very existence of rights to participate in management for a public company, on the theory that the market could be unaware of such rights and so be misled.[434]

Finally, some extra layers of regulation, such as the Listing Rules (including the Combined Code on Corporate Governance) only apply to quoted companies. However, these rules do not directly affect the liability of directors.

United States

The United States does not have a separate statute governing smaller or privately held corporations. Thus, it lacks the distinction, present in Russia and some other countries, between joint stock companies and limited liability companies. Therefore, in general, the fiduciary duties and liabilities of directors are, in principle, similar in public and private companies. In practice, some remedies, especially the oppression remedy, are employed principally for private companies.

A source of confusion: the United States has a form of legal entity known as a limited liability company. This is a hybrid between a partnership and a corporation, and is not similar to a limited liability company as the term is used in Europe or in Russia.

Some states, including Delaware, have separate chapters of their corporation law devoted to offering a separate, simpler set of rules for small companies, with a limited number of shareholders. These "close corporation" chapters are often not used, even for companies that are eligible to use them. Moreover, they do not address the fiduciary duties of directors and officers, which are the principal source of liability. Those duties are established by common law, not by statute. There is no explicit differentiation in the formulation of the duties, or of the business judgment rule defense, between larger and smaller companies.

Securities law does impose additional obligations on the directors of public companies. For example, these companies must have an audit committee of the board of directors. That responsibility, as a practical matter, may entail additional responsibilities, and additional potential for liability if those responsibilities are not completed. However, the liability would arise under the general duties of care, loyalty, and disclosure.

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433 See Law Commission for England and Wales, *Shareholder Remedies*, Consultation Paper No. 142 (1996)), at 91-92, and the statistics at pp. 236-238; updated in Law Commission for England and Wales, *Shareholder Remedies*, Final Report No 246, at 177-180.

434 See *Re Blue Arrow plc* [1987] BCLC 585; Law Commission for England and Wales, *Shareholder Remedies*, Consultation Paper No. 142, at 91-92.

Summary and recommendations

The recommendations in this Report are intended to be appropriate for large, public, open joint stock companies. There are three distinctions that might be relevant, in assessing which of the recommendations should apply to other companies:

- Within the class of open joint stock companies: public companies, which have issued securities to the public, versus nonpublic companies.
- Within the class of joint stock companies, open versus closed joint stock companies. Closed joint stock companies cannot issue securities to the public, because of limitations on this form of legal entity established by the Civil Code and the JSC Law, including limits on the maximum number of shareholders of a closed joint stock company. JSC Law art. 7(3).
- Joint stock companies versus limited liability companies. The details of the Law on Limited Liability Companies are beyond the scope of this Report, but it may still be appropriate to discuss generally what differences there should be in fiduciary duties between joint stock companies and limited liability companies. This is especially true since the distinctions in practice between closed joint stock companies and limited liability companies are often small. Thus, one would expect that similar rules on the duty of directors should apply to these two types of companies.

Public versus nonpublic open joint stock companies

We consider first the distinctions between public and nonpublic companies, while considering only open joint stock companies. Such a distinction could be drawn, in practice, by limiting specific rules based on whether a company has issued common shares or other securities to the public, or based on the number of shareholder-possessors of common shares. The JSC Law currently includes a number of rules which depend on the number of shareholders. The JSC Law also sometimes distinguishes directly between companies that have issued securities to the public and companies that have not. Similar distinctions between public and nonpublic joint stock companies can be found in the joint stock company laws of some of the comparison countries.[435]

These rules demonstrate that the same rules should not invariably apply to companies of all types. They also show that there are different ways of describing the application of rules that, in practice, are meant to apply only to public companies.

In our opinion, the JSC Law does not go far enough in distinguishing between public companies and nonpublic companies. For example, the JSC Law requires cumulative voting for all companies. There is a policy basis for this requirement for public companies, but we see no reason why this requirement was extended, in 2001, to cover

435 In Germany, see, for example, AktG §§ 3(3), 20(8), 21(5), 58(2), 67(6), 110(3), 125(1)(.3), 130(1)(.2), 134(1), 171(2), 328(3). In France, see, for example, Code de Commerce Articles L. 225-4; 225-2.

all companies (JSC Law art. 66(1)).[436] Similarly, the 2006 amendments added rules on takeover bids. These rules are appropriate for public companies, but the JSC Law applies them to all open joint stock companies, including nonpublic companies (JSC Law art 84.1(1)). In our view, it is important that similar mistakes be avoided with respect to the proposals in this Report connected with the liability of directors and managers.

The table below is based on these general principles. It indicates which of the recommendations we have made should apply to all companies, to all joint stock companies, to open joint stock companies, or only to public joint stock companies. We have no strong opinion on whether the distinction between public and nonpublic joint stock companies should be based on number of shareholders or on whether a company has issued shares to the public.

Especially for closed joint stock companies and limited liability companies, we propose that many rules should be "default rules," which can be changed in a company's charter. This approach is consistent with the overall structure of the JSC Law and the Law on Limited Liability Companies. Under the JSC Law, some rules that are mandatory for public companies do not apply to nonpublic joint stock companies, or are only default rules for these companies. Moreover, some rules that are included in the JSC Law are not included in the Law on Limited Liability Companies, or else are included only as default rules that can be changed in a company's charter.

There will also be other differences between the rules that are appropriate for public companies and rules that would be appropriate for non-public companies. For example, the duty of good faith of a controlling shareholder, proposed in subchapter 1.5, does not make sense for a company with only one shareholder. For limited liability companies, proposals that apply to the board of directors will have to be modified to instead apply to a meeting of participants in the limited liability company. And so on.

Summary of recommendations for different types of companies

This Report generally provides recommendations for members of the board of directors and executive organ of an open joint stock company whose shares are publicly traded ("public companies"). This table indicates our principal recommendations, and indicates which recommendations should apply only to public companies, which should apply to open joint stock companies (open JSCs), which should apply to all JSCs, and which should apply to limited liability companies (LLCs). In general: (i) recommendations for directors also apply to the members of the company's executive organ, to an external manager or managing organization, and to the directors and members of the executive organ of a managing organization who adopt decisions on behalf of the company; (ii) recommendations for transactions involving a conflict of interest also apply to controlling shareholders; and (iii) references to transactions by a company include transactions by a subsidiary or dependent company. Some recommendation are discussed in more than one chapter of this Report. These recommendations are indicated below only once.

436 For discussion of the value of cumulative voting in the Russian context, see Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARVARD LAW REVIEW 1911-1981 (1996), at 1947-1949, at http://ssrn.com/abstract=10037.

Chapter	Recommendation	Applies to
1.2 Concept of reasonableness and good faith	No need to amend Civil Code art. 53 Changes to the JSC Law are recommended: • to specifically state that the obligation of directors to act reasonably includes the obligation to become reasonably informed before adopting a decision • to adopt a form of the business judgment rule, to protect directors against liability for adopting decisions that do not involve a conflict of interest • to specify the core elements of the duty of good faith • to establish a duty of disclosure for directors, including the obligation to disclose any conflicts of interest • to extend the duty of good faith to a controlling shareholder, for transactions by the company involving a conflict of interest.	all companies open JSCs; default rule for other companies all companies open JSCs, default rule for other companies all companies
1.3. Presumption of reasonableness and good faith	Changes to the JSC Law are recommended: ➢ to adopt a presumption of reasonableness, if the directors act based on reasonable information and without a conflict of interest ➢ this presumption of reasonableness can be embodied in a form of the business judgment rule ➢ to specify that there is no presumption of reasonableness, for a transaction which involves or may involve a conflict of interest may exist ➢ to specify that there is a presumption of lack of good faith, for a transaction which involves a conflict of interest	all companies public JSCs; default rule for other companies all companies public companies, default rule for other companies
1.4 Concept of self-interest	Changes to the JSC Law are recommended: ➢ to define the concept of a conflict of interest for purposes of fault-based liability under art. 71 of JSC Law ➢ to specify that a conflict of interest can be direct or indirect For improved functioning of the board of directors, changes to the JSC Law are recommended: ➢ to permit companies to provide in their charters for delayed review by the board of directors of de minimis transactions which may involve a conflict of interest ➢ to permit the members of the board of	all companies all companies all companies all companies

Chapter	Recommendation	Applies to
	directors to unanimously waive the requirements for advance notice of meetings of the board of directors	
1.5 Transactions with controlling shareholder	Changes to the JSC Law are recommended: ➢ to require controlling shareholder to provide material information to the company about a transaction for which the controlling shareholder has a conflict of interest; ➢ to specify that it is a violation of the duty of good faith for a controlling shareholder to put pressure on the company's directors to approve a transaction for which the controlling shareholder has a conflict of interest ➢ to specify that directors who approve a transaction in which the controlling shareholder has a conflict of interest, including non-interested directors, have the burden of proving that they were informed, and made a reasonable decision,	all companies JSCs JSCs
1.6. Additional bases for civil liability	Bases of liability other than under the JSC Law are generally beyond the scope of this Report. Changes to the JSC Law are recommended, in addition to the changes discussed above: ➢ to add a duty of confidentiality of company directors for a company's nonpublic business information ➢ to require the company's executive organ to provide information to the board of directors ➢ to provide that it is a violation of the duty of good faith to knowingly provide incomplete or misleading information to the board of directors. Changes to the Law on Capital Markets are recommended: ➢ to require all directors, including non-executive directors, to review a company's prospectus for a public offering and satisfy themselves that the prospectus is reasonably accurate and complete, with liability for gross negligence if they do not comply with this obligation	open JSCs, default rule for other companies public companies all companies public companies

Chapter	Recommendation	Applies to
1.7. Losses, Remedies for breach of duty	The measure of damages (ubuoytki) specified in the JSC Law art. 71 and Civil Code art. 15 is sufficient. No changes are recommended. Changes are recommended to the JSC Law: ➢ to specify that the remedy of invalidation of the transaction, in JSC Law arts. 79, 84 should be applied only if invalidation will not cause harm to third parties	 all companies
2. Legal nature of relationship between a director and a company	This relationship is primarily contractual in nature. Changes to the JSC Law are recommended: ➢ to specify that, with limited exceptions, only a general shareholder meeting can dismiss a director from his position on the board of directors ➢ to specify that a director may voluntarily resign from his position before the end of his term ➢ to specify that if a director dies or resigns before the end of his term, a replacement director may be elected by a general shareholder meeting, without reelecting an entire new board ➢	 JSCs JSCs JSCs
3. Different liability rules for different members of management organs	The same duties and the same standards of liability should generally apply to all directors, with the following nuances: ➢ Distinctions between different types of directors, for example non-executive chairman versus other non-executive directors, new director v. long-serving director, member of specific committees, etc. do not need to be stated in the law; and can be left to the courts to determine ➢ If litigation against non-executive directors, based on breach of the duty of reasonableness, becomes a significant risk, it may be appropriate to establish a different standard of liability for non-executive directors, or to limit their monetary liability for decisions that do not involve a conflict of interest Changes to the JSC Law are recommended: ➢ to excuse a government-appointed director from compliance with the duty of reasonableness and the duty to act in the	 all companies public companies JSCs

Chapter	Recommendation	Applies to
	company's interests for adopting a decision, without a conflict of interest, in accordance with written instructions from the director's superiors in the government	
4. Application of labor code to company executives	Changes are recommended to the JSC Law: ➢ ➢ to clarify that an executive director who is dismissed as a manager by the board of directors retains his position on the board of directors ➢ to provide that a director who is dismissed early by decision of a general shareholder meeting should receive compensation for the remainder of his term, unless the dismissal is for good cause	JSCs public companies
5. Liability of managing organization (individual manager) and employees of managing organization	Changes are recommended to the JSC Law: ➢ to clarify that an individual manager, or a managing organization, has the same duties as a member of the board of directors; ➢ to clarify that an individual manager, or a managing organization, has the same duties as a member of the board of directors; ➢ to specify that a managing organization should be liable in any circumstance in which the persons within the managing organization who adopt decisions on behalf of the managed company would be liable if they directly managed the company; ➢ to specify that the persons within a managing organization, who adopt decisions on behalf of a company, have the same duties to the managed company as if this person were a director of the managed company ➢ to specify that if a managing organization is found liable for breach of duty to the managed company and has insufficient assets to pay a judgment, the persons within the managing organization who adopt decisions on behalf of the company should be secondarily liable ➢ to adopt the concept of a de facto director, who acts as if he had an official position with the company, and should have the same duties to the company as an official director.	JSCs JSCs JSCs JSCs JSCs JSCs
6. Liability in	We do not recommend additional liability for	no changes are

Chapter	Recommendation	Applies to
the case of bankruptcy	directors of an insolvent company, beyond the liability which already exists in the JSC Law and the Bankruptcy Law; We do not recommend liability of directors for not causing the firm to file for insolvency proceedings as it approaches bankruptcy.	recommended
7. Liability for actions involving subsidiary and dependent companies	Protection of creditors of subsidiaries should be addressed in the Bankruptcy Law, which is beyond the scope of this Report. Changes are recommended to the JSC Law: ➢ to specify that when a parent company, or its managers, in fact manages a subsidiary (or dependent company), the company and the persons who manage the subsidiary should face the same liability as a managing organization and the persons within a managing organization who adopt decisions on behalf of a managed company	JSCs
8.1 Procedural aspects of directors' liability	Changes are recommended to the JSC Law, the Arbitrazh Procedure Code, and the interpretive rules of the Supreme Arbitrazh Court: ➢ to specify that disputes involving joint stock companies and their shareholders should be heard exclusively by the arbitrazh courts ➢ to provide the same procedures for a shareholder suit for breach of duty and for completion of a self-interested transaction ➢ to provide similar procedures for other instances in which a shareholder can bring an action under the JSC Law, including actions to invalidate a decision of a general shareholder meeting or a decision of the board of directors ➢ to specify that if a shareholder brings a successful derivative suit, the company should pay the shareholders' expenses to bring the suit, incurred in accordance with ordinary business practices, to the extent these expenses are not paid by the losing party; ➢ to specify that if a derivative suit is unsuccessful, the shareholder should pay the defendants' legal costs only if the court finds that the was an abuse of rights by the plaintiff in bringing the suit;	JSCs JSCs JSCs JSCs public companies; default rule for other JSCs JSCs JSCs

Chapter	Recommendation	Applies to
	➢ to specify that a derivative suit is brought by a shareholder, with the company as a third party beneficiary ➢ to provide the trial judge with discretion on what role the company should play in a derivative suit.	public companies
8.2 Abuses in suits by shareholders	Changes are recommended to the JSC Law and the Arbitrazh Procedure Code: ➢ to require notice to all shareholders, an opportunity to participate in a derivative suit or to elect not to be bound by the outcome of the suit ➢ to require disclosure of conflicts by the plaintiff-shareholder; ➢ to specify that it is a breach of duty for a company's directors to procure an improper settlement or dismissal of a suit, on terms which do not protect the company's interests; ➢ to require shareholder approval of a settlement of a derivative suit; ➢ to require judicial review of an agreement to settle a derivative suit.	JSCs public companies JSCs public companies public companies
8.3 Powers of regulator in civil actions	We consider the question, whether the FSFM should have the power to bring a civil action to enforce the duties of directors and controlling shareholders of public companies under company law, to be a close one. We have no recommendations either in favor of or against this power.	no changes are recommended
9.1. Compensation by company for damages and expenses	Changes are recommended to the JSC Law [and other appropriate laws] *Compensation for damages* ➢ to specify that a company may agree in advance, by contract or through a provision in the charter or bylaws, to compensate directors for amounts paid to third parties arising out of their official duties on behalf of the company, for actions not involving a conflict of interest or personal benefit, provided that the compensation is approved by non-interested shareholders and a court finds that the director has acted in good faith and in the interests of the company; *Compensation for legal and other expenses* ➢ to specify that a company may agree in advance, by contract or through a provision	JSCs, default rule for LLCs JSCs, default rule for LLCs

Chapter	Recommendation	Applies to
	in the charter or bylaws, to compensate directors for legal and other expenses for civil suits and administrative and criminal proceedings relating to their actions with respect to the company, provided that the compensation is or advancement of expenses is approved by non-interested shareholders, and that the director must repay any advanced legal expenses if a court finds that the director did not acted in good faith and in the interests of the company; ➢ to specify that a company may advance legal expenses, without regard to a director's ability to repay; ➢ to specify that a company shall compensate directors for legal and other expenses if the director is successful in defending against a civil suit or other proceeding	JSCs, default rule for LLCs JSCs, default rule for LLCs
9.2 Insurance against directors' liability	Changes are recommended to the JSC Law and the Civil Code: ➢ to permit a company to purchase directors' and officers' liability insurance for its directors, provided that the amount, principal terms, and cost of the insurance are disclosed to shareholders and approved by non-interested shareholders at a general shareholder meeting. ➢ to specify that D&O insurance should be permitted to cover legal expenses in all cases, including administrative and criminal proceedings; The specific terms and amounts of D&O insurance do not need to be specified in the law.	all companies all companies all companies
10. Application to nonpublic open companies, closed companies, limited liability companies	Changes are recommended to the Law on Limited Liability Companies: ➢ selected recommendations concerning the duties of directors and controlling shareholders generally should also apply to all types of companies, including limited liability companies and closed joint stock companies ➢ recommendations concerning the power of the FSFM apply only to public companies ➢ some recommendations for public companies can be adopted in simpler form for limited	see specific recommendations in this table public companies see specific recommendations in this table

Chapter	Recommendation	Applies to
	liability companies ➢ some recommendations for public companies should be default rules for other companies	see specific recommendations in this table
11. Practical experience in other countries.	There are no recommendations in this chapter	no changes are recommended
12.1 Administrative offences	We do not recommend that the FSFM should have the power to obtain administrative fines or penalties, either directly or through court proceedings.	no changes are recommended
12.2 Procedural aspects of administrative liability	Change is recommended to the JSC Law and the Administrative Procedure Code: ➢ to provide that the FSFM should have the power to investigate breach of duty by directors of public companies ➢ to give the FSFM the power to bar directors of public companies from serving as a director or member of the executive organ of a public company, based on a serious breach of duty;	public companies public companies
13.1 Criminal offenses	We do not recommend that the a breach of duty to the company under company law should give rise to criminal liability. Existing criminal law addresses theft and other serious misuse of company positions for personal advantage.	no changes are recommended
13.2 Procedural aspects of criminal liability	We do not recommend that the FSFM have the power to bring a criminal prosecution. We do not recommend special procedural rules to govern any criminal liability for breach of company law	no changes are recommended

Open versus closed joint stock companies

The same rules should not invariably apply to both open and closed joint stock companies. At the same time, the distinctions between open and closed companies in the JSC Law are primarily technical in nature. They relate to offerings of shares, number of shareholders, and so on, and not to the duties owed by directors to the company.

The recommendations above on which rules should apply to public companies, which rules should apply to open joint stock companies, and which rules should apply to all joint stock companies are based on these general principles.

Joint stock companies versus limited liability companies

Some of the rules discussed in this Report are appropriate for all companies, but many are not appropriate for limited liability companies. Even when a particular rule is appropriate for a limited liability company, it may be desirable to make the rule a default rule, that can be modified in the charter of a particular company. One of the strengths of the limited liability company form is that these companies can operate under a simpler set of rules, which provide a large measure of flexibility for the founders of a particular company to choose a set of rules that are appropriate for their particular situation.

Chapter 11. Practical experience with liability for breach of duty under company law.

Issue: What has been the practical experience of other countries in imposing liability on members of the board of directors for breach of fiduciary duty under company law?

Russian context

Russia has limited experience with holding the members of management organs liable under JSC Law art. 71. There are number of reasons for this, including lack of a clear description of the duties of members of management organs, for nonfulfillment of which they could be held liable. Thus, the terms "reasonableness" and "good faith" are very imprecise and make it difficult to determine in practice what kind of behavior on the part of a management organ member is necessary in order for him to be considered to be acting unreasonably or not in good faith. Courts often confuse these concepts with that of fault. There are also serious practical difficulties in establishing both fault and a cause-and-effect relationship between a management organ member's actions and subsequent losses. The lack of clear rules on which courts have jurisdiction over these cases is a further obstacle.[437]

When shareholders nevertheless file a claim against a company's management organs, the judgment is, on the whole, rarely in their favor. We have, however, provided examples in previous chapters of a few significant cases in which the members of management organs were held liable under JSC Law art. 71. In one of these instances the court ruled that the transaction was completed without any consideration of the company's interests,[438] while in another it pointed to the apparent complete disinterest of the members of the company's management organs in fulfilling their duties.[439] Additional examples could be provided where management organ members were found liable for damages that they caused to a company.[440] These judgments, however, are more the exception than the rule and occur only occasionally.

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437 We discuss the jurisdiction of the regular and arbitrazh courts in Chapter 8.

438 Decision of the Federal Arbitrazh Court of the Moscow District No. KG - A40/547-02 (Feb. 19, 2002) (Постановление Федерального арбитражного суда Московского Округа от 19 февраля 2002 г, № КГ-А40/547-02).

439 Decision of the Federal Arbitrazh Court of the Volgo-Vyatskiy District No. A43-2160/03-25-102 (Sep. 9, 2003) (Постановление Федерального арбитражного суда Волго-Вятского Округа от 09.09.2003, № А43-2160/03-25-102).

440 See, for example Decision of the Federal Arbitrazh Court of the Western Siberian District No. F04-3476/2006 (23459-A75-16) (Jun. 15, 2006) (Постановление Федерального Арбитражного Суда Западно-Сибирского Округа от 15 июня 2006 года, N Ф04-3476/2006 (23459-А75-16)); Decision of the Federal Arbitrazh Court of the Northern Caucasus District No. F08-4937/2006 (Oct. 4, 2006) (Постановление Федерального Арбитражного Суда Северо-Кавказского Округа от 4 октября 2006 года, № Ф08-4937/2006).

Austria

Austrian case law on director liability has remained rare. We are aware of only three reported cases involving outside directors where liability rested on the equivalents of the provisions of company law described here (i.e. director's general duty of care). All were brought by the insolvency administrator. Generally, claims to damages resulting from the failure to file for bankruptcy when the firm would have legally required to do so have been of far greater practical significance than directors' general duties under company law (see Chapter 6).

Canada

It is impossible to do more than speculate on how directors' duties operate in practice in Canada since there has not been a detailed, empirical examination of the topic. One point that is reasonably clear is that in practical terms directors are not often found liable under corporate legislation. Corporations do not make a habit of suing directors for a breach of duty under corporate law because a corporation's board determines whether a company will sue and directors are not inclined to sue themselves or their colleagues. This is crucial because the received wisdom in Canada is that the "core" duties directors owe are owed solely to the corporation.[441] Derivative suits alleging breaches of duty by directors can be launched by minority shareholders under Canadian corporate legislation but such litigation is not particularly common. On the reasons, see Chapter 8.

Securities regulation, which is regulated exclusively by the provinces, generates more concern for directors than corporate law. In practice, however, there have been few reported cases involving liability claims brought against directors. One reason suits against directors are uncommon is uncertainty concerning the viability of class actions. Also, in cases that are brought, the most likely outcome is an out-of-court settlement, usually funded by D&O insurance or by company funds, which does not involve any personal payment by directors.[442]

Another provision that has generated concern among directors is § 227.1 of the federal Income Tax Act, which in essence imposes a duty on directors to act with reasonable prudence to prevent failures by their companies to remit tax due. We discuss this provision in subchapter 1.6. How often this has resulted in directors being held liable is not known. However, whatever dangers exist in practice are most acute for directors of small companies, since outright default on tax obligations is a rare occurrence for public companies, absent an abrupt financial collapse.

Directors' potential liability for unpaid wages is also a serious worry. Through a combination of corporate legislation and employment standards law, directors of an insolvent company that fails to pay its staff can end up being jointly and severally liable

441 The Canadian Supreme Court has recently cast doubt on this proposition with the duties of care, skill and diligence. See *People's Department Stores v. Wise* [2004] 3 S.C.R. 461). However, this case arose under Quebec corporate legislation and the Quebec Civil Code. The extent to which Ontario and Canada's other common law provinces will follow this case is not clear.

442 Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEXAS LAW REVIEW 1385-1480 (2006), at 1445-47.

for up to six months of unpaid wages and related employment benefits (e.g. CBCA § 119; OBCA § 131, see the discussion in chapter 6). Though there is much discussion of the risks directors face due to unpaid wages, it appears that not many suits are brought against directors, particularly directors of public companies. The tiny handful of reported cases where directors have been held liable for unpaid wages have involved private companies.[443]

There are a large number of statutory provisions under which directors can be punished by way of a fine or a similar penalty. In practice, however, such sanctions are only rarely imposed on directors.[444]

France

We cannot provide empirical data on directors' liability in France. The extent to which French company law books discuss the liability rules may indicate that they are regarded as significant and interesting but perhaps not the most important part of company law. The main reason for this may be that due to the lack of incentives to sue (see the discussion in Chapter 8), derivative suits are not very frequent in France. The role of criminal law as a source of risk to directors has been relatively significant, in contrast to a number of other countries, where this risk is largely absent (see Chapter 14).

Germany

As the empirical evidence compiled by Brian Cheffins and Bernard Black shows, litigation against outside directors has been rare in Germany.[445] There are more cases concerning members of the management board (often related to the insolvency of the company). It remains to be seen whether the new procedure introduced to facilitate derivative litigation introduced in 2005 (described in Chapter 8) will produce a significant amount of litigation. However, an educated guess is that the rules on payment of legal fees will continue to provide significant deterrents to these suits.

Japan

In Japan, outside directors are able to sign a contract with their company that limits their liabilities when the company charter allows such a contract (Japanese Commercial Code art. 427 ¶ 1). A proposal to insert such a provision into the charter requires the consent of company's statutory auditor (Japanese Commercial Code art. 427 ¶ 3). This permission to provide for indemnification in the charter is limited to outside directors. Similar protection is not available to executive directors.

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443 See, for example, *Canadian Automatic Data Processing Services Ltd. v. CEEI Safety and Sec. Inc.* [2004] 192 Ontario Appeal Cases 152; *Proulx v. Sahelian Goldfields Inc.* [2001] 55 Ontario Reports (3d) 775.

444 Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEXAS LAW REVIEW 1385-1480 (2006), at 1474-1475.

445 *Id.* at 1420-1433.

For executive directors (and outside directors) of a Japanese company, the amount of liability can be limited by a special resolution at the shareholders' meeting or by a board resolution based upon authorization in the charter (Japanese Commercial Code art. 425 ¶ 2; art. 426 ¶ 1).

Korea

In Korea, shareholder rights activists have thus far initiated most of the lawsuits against managers under corporate law. These suits do not usually include outside directors in their lawsuits. However, outside directors have been sued in a couple of control contests. In fact, outside directors are relatively more vulnerable and are popular targets when the contest becomes heated.

There have been only two cases in which outside directors were held jointly and severally liable with executive directors at the trial level. One case was very unique and the damages awarded by the Pusan District Court in 2003 were 140 billion Korean won ($140 million). The controlling shareholder-manager of the company committed grave misconduct while the outside director (a university professor) did not bother to check the misconduct. As the company became a hostile takeover target, the bidder sued the directors of the company including the outside director. No information on who paid the judgment is available. The other case was brought against the eight former directors of LG Chemical (currently, LG Corporation). Two outside directors (one being former President of Seoul National University) were involved in the decision by the board of directors to approve the sale of LG Petrochemical shares to controlling shareholders and directors of the company for a below-market price. In 2006, the Seoul Southern District Court awarded 40 billion ($40 million) Korean won to the company holding the directors liable.[446] However, instead of finding all directors jointly and severally liable for the entire amount, the court ruled that the liability of the outside directors should be limited to 4 billion Korean won, 10% of the damages. The controlling shareholders who benefited from the sale paid all damages, and the outside directors did not pay.

The KCC states that the liability of directors to their company may be released by the unanimous consent of the shareholders of the company. KCC art. 400. However, obtaining such a release is not practicable for a public company. A proposed amendment to the KCC includes a provision that limits liabilities of executive directors and outside directors to six times their annual compensation. (In 2000, a group of international consultants to the Korean Ministry of Justice, including Professor Bernard Black and Mr. Barry Metzger, recommended that the liability of independent directors should be limited to a multiple (such as five times) of the director's total compensation from the company (including the value of non-cash compensation) in cases in which they have acted in good faith.[447])

446 Case No. 2003-Gahap-1176.

447 See Bernard Black, Barry Metzger, Timothy O'Brien & Young Moo Shin, *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness*, 26 JOURNAL OF CORPORATION LAW 537-609 (2001), at 579-580, at http://ssrn.com/abstract=222491.

United Kingdom

As is the case with Canada (see accompanying report) it is impossible to state definitively how directors' duties operate in practice since there has not been a thorough examination of the topic with regard to executive directors. However, since all directors are formally held to the same legal standards, research done by Cheffins and Black on the liability of nonexecutive directors is instructive.[448]

They report that outside directors of U.K. companies have little to fear from lawsuits based on a claim of a breach of duty under company law. Companies generally refrain from suing directors because the board determines whether a company will sue, and directors are not inclined to sue themselves or their colleagues. Derivative litigation, due to procedural and practical constraints has been virtually non-existent in the U.K. (See Chapter 8). Hence, as a practical matter, the only situation where litigation against directors is a realistic possibility is where there has been a change of management, either when the company has been sold and a new board has been appointed or where the company has become insolvent and a liquidator has taken control.

Many of the practical constraints that limit suits against outside directors would also apply to executive directors. However, where there has been active malfeasance, such as an accounting fraud, there may be greater willingness on the part of the company to sue its former executives, and perhaps greater willingness of an insolvency receiver or liquidator to do so.

Securities litigation is virtually unknown in Britain. Lawsuits against companies or their directors based on allegations that the offering documents for a public offering of securities are misleading are rare. The explanations include procedural difficulties associated with class action and other multi-party litigation, fears of an adverse "loser pays" order regarding legal fees, and the limited ability of lawyers to use U.S.-style contingency-fee arrangements.

Suits against companies or their directors arising from allegedly misleading periodic disclosures -- as contrasted with disclosures during an offering of securities -- are still rarer. This not only is because of the procedural considerations just discussed, but also because such a suit can only succeed in the rare event that the information was provided to guide a specific purchase or sale of shares. (See *Al-Nakib Investments (Jersey) Ltd.* v. *Longcroft*, [1990] 3 All E.R. 321, where the court adopted a similar approach in a case involving alleged misstatements in the prospectus for a public offering of shares.)

Along the same lines, there have been no reported cases involving allegations of wrongful trading (involving the failure of the directors to timely file for insolvency, when it is apparent that the company is insolvent) brought against directors of public U.K. companies. Since proving wrongful trading will often be difficult and the litigation is likely to be time-consuming and expensive, liquidators typically decide that it is not worthwhile to sue.

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448 See Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEXAS LAW REVIEW 1385-1480 (2006), at 1399-1420, 1470-1472.

Finally, with criminal liability, prosecutions are undertaken only under a small handful of sections of the Companies Act 1985 and the infractions prosecuted are not of the type directors of even the smallest public company are likely to commit (for example, failure to deliver annual accounts or to keep proper accounting records). Similarly, prosecutions of directors of public companies under environmental legislation or workplace safety laws are rare. There is no reason to expect this to change under the Companies Act 2006.

While lawsuits against directors of U.K. public companies are rare, it is worth remembering that when litigation does occur, the proceedings will be time-consuming and stressful for the directors involved. This was the case, for instance, with a lawsuit brought by Equitable Life, a major British insurer that nearly went bankrupt in the late 1990s. The old board was replaced after the debacle, and the new board sued the auditor and fifteen former directors, including nine non-executives, for damages exceeding £3 billion. The non-executive directors sought to have the claim against them dismissed, but this application failed.[449] Equitable Life ultimately dropped its claim and indemnified the defendants for legal expenses incurred. Nevertheless, for the former directors the case was an immense source of stress, since they faced the threat of financial ruin for a number of years.

United States

The discussion below is taken from Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, Texas Law Review, volume 84, pages 1385-1480, at 1392-1398 (2006), which in turn summarizes the research on the United States in Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, Stanford Law Review, volume 58, pages 1055-1159 (2006). Only selected footnotes are included in this excerpt, and deletions and small stylistic changes are not marked.

While this research focuses on outside directors, much of it is relevant to inside directors and officers.

> Most people outside of the United States would expect that, in America's litigious environment, directors face considerable liability risks. For "insiders" who act in a self-serving or dishonest fashion, there is anecdotal evidence to support the received wisdom, such as the 2005 agreement by Bernard J. Ebbers, the founder and former chief executive of World Com convicted of fraud, to surrender nearly all of his personal fortune—about $40 million—to investors who lost billions when the company went bankrupt.[450] For outside directors of public companies, there is a real risk of being a defendant in a case resulting in a cash settlement or a verdict in favor of the plaintiff. However, when it comes to an outside director actually making an out-of-pocket payment in a settlement or following a trial,

449 *Equitable Life* v. *Bowley* [2004] 1 BCLC 180.

450. For additional examples of "insiders" in U.S. public companies who have made out-of-pocket payments, see John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUMBIA LAW REVIEW 1534-1586 (2006), at 1552-1553 (arguing, however, that insiders do not make personal payments often enough or large enough for civil liability to constitute a meaningful deterrent to misconduct).

non-U.S. views of the risk faced by U.S. directors will likely be out-of-step with U.S. reality.

To put matters into context, the legal environment in the United States is uniquely hospitable to litigation against directors. Multiple features of the American legal system contribute to this unique environment. First, litigants in the U.S. pay their own legal expenses, regardless of whether they win or lose in court.[451] Other countries generally require the losing side to pay at least some of the successful party's legal costs, which deters some claims.

Second, in the U.S., the class action suit under securities law and the "derivative" suit under corporate law (litigation brought by shareholders on a company's behalf) are well-established devices for solving collective action problems that otherwise discourage shareholders owning a small percentage of shares from launching proceedings against directors. Class action certification is routinely available for a securities lawsuit brought by investors against directors, and most securities suits are framed as class actions.[452] Similarly, procedural rules governing derivative litigation allow any shareholder to bring proceedings on behalf of the corporation against a director for violating duties formally owed to "the corporation."[453] These suits face procedural hurdles, but derivative-suit litigants surmount them reasonably often.

Third, to a unique extent, the U.S. legal system treats plaintiffs' attorneys as entrepreneurs who seek out legal violations and suitable clients rather than waiting passively for potential clients to come to them. If a class action securities suit is successful at trial or (much more likely) settled out of court, the judge will generally award legal fees out of the proceeds, usually as a percentage of the class recovery. When a derivative suit is settled, the settlement agreement will typically recite that the suit has conferred a "substantial benefit" on the corporation, and the corporation will pay the plaintiffs' attorneys' fees. Judges must approve settlements, but they rarely object to the parties' agreement on fees.[454]

With the setting for lawsuits thus made congenial, shareholder litigation is common in the U.S. Between 1991 and 2004, 3,263 federal securities class action

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451. NEIL ANDREWS, ENGLISH CIVIL PROCEDURE: FUNDAMENTALS OF THE NEW CIVIL JUSTICE SYSTEM 1001 (2003); John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUMBIA LAW REVIEW 669-727 (1986), at 670 note 2. In the U.S., the federal Private Securities Litigation Reform Act of 1995 authorized judges to order plaintiffs' attorneys to pay the cost of defending a securities suit if the plaintiff has not complied with specified federal civil procedure rules. *See* Securities Exchange Act of 1934 § 21D(c). To our knowledge, judges have yet to invoke this provision.

452. For a summary of class certification under the Federal Rules of Civil Procedure, see CHRISTOPHER HODGES, MULTI-PARTY ACTIONS 206–207 (2001).

453. The relevant rule in federal courts is Federal Rule of Civil Procedure 23.1. We discuss the substantive rules on when judges will allow a derivative suit to proceed in chapter 8.

454. ROBERT W. HAMILTON, THE LAW OF CORPORATIONS IN A NUTSHELL 540-541 (5th edition, 2000).

cases were filed in U.S. federal courts, an average of just over 230 each year.[455] A study of Delaware court filings for 1999–2000 (Delaware is where most litigation involving fiduciary breaches by public company management takes place) implies that approximately 140 public companies annually face lawsuits alleging breaches of fiduciary duty by their directors.[456]

There is little data currently available on how often outside directors are named as defendants in either securities suits or in fiduciary duty suits. It is reasonable to assume, however, that there are dozens of suits filed against outside directors each year.[457] Despite the volume of litigation, there is only a small chance outside directors of U.S. public companies will pay out of their own pockets. An exhaustive study we carried out in the United States covering 1980 to 2005 bears this out.[458]

Our study of outside director liability in the U.S. uncovered eight instances in which outside directors made personal payments in securities law civil suits, three of which involved only expenditures on legal fees. There were also four instances in which outside directors paid damages in cases arising under corporate law and one case involving the Employee Retirement Income Security Act of 1974 (ERISA) where the outside directors did likewise. Finally, there was one instance in which an outside director who had engaged in self dealing, which was known to the CEO but not disclosed to the board of directors, disgorged the illicit profits secured and paid fines to conclude a civil action by the SEC and a criminal action by a New York prosecutor.[459]

The fact that an outside director of a public company faces only a remote chance of breaching duties owed to the company under corporate law is one reason why out-of-pocket liability is rare in the U.S. For instance, as long as a director acts without a conflict of interest, a judge will review board actions pursuant to the "business judgment rule" and, if the board was tolerably well-informed, will

455. ELAINE BUCKBERG, TODD FOSTER, RONALD MILLER AND STEPHANIE PLANCICH, NERA ECON. CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: BEAR MARKET CASES BRING BIG SETTLEMENTS 2 (2005). NERA reports that 1,897 of these cases had been settled as of year-end 2004.

456. Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VANDERBILT LAW REVIEW 133-209 (2004), at 168–169.

457. Preliminary data collected by some of us for another project indicates that, from 2000 to 2003, outside directors were named as defendants in 19% of securities class actions. This preliminary research also finds that the number of fiduciary duty cases that name outside directors as defendants and involve claims for damages is substantially smaller than the 140 cases per year reported in Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VANDERBILT LAW REVIEW 133-209 (2004), but could be on the order of 20 cases per year. In contrast, the company's CEO and CFO were named in a majority of securities class actions. John Armour, Bernard Black, Brian Cheffins & Richard Nolan, *Private Enforcement of Corporate and Securities Law: An Empirical Comparison of the US and UK* (working paper, 2008).

458. Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STANFORD LAW REVIEW 1055-1159 (2006).

459 These 14 instances of out-of-pocket liability involved 13 companies. The Enron directors paid to settle both a securities case and an ERISA case.

dismiss a suit for breach of the duty of care without inquiring into the merits of the decision. The outcome in the recent, highly publicized *Disney* lawsuit, involving a claim that the directors had ignored their duties and should be liable for approving a compensation agreement with Disney President Michael Ovitz that paid him $140 million when he was fired after being employed for less than a year, illustrates this point. The judge rejected the claim against the Disney directors despite his observation that "there are many aspects of defendants' conduct that fell significantly short of the best practices of ideal corporate governance."[460] Also, most public companies take advantage of provisions in state corporate law allowing them to eliminate director liability for breaches of the duty of care.[461]

Under federal securities law, a judge will dismiss a suit based on allegations of misdisclosure unless the plaintiffs can plead facts indicating liability with sufficient particularity. Many claims brought against outside directors are set aside on this basis. For lawsuits that survive this preliminary hurdle, most settle. If the company is solvent, the outside directors will pay nothing since the company will either pay damages directly or indemnify them for any liability incurred pursuant to provisions in state corporate legislation that authorize the indemnification of directors who have acted in good faith and in the best interests of the company.[462]

Once a public company becomes insolvent, its outside directors face greater risk. Self-dealing aside, all of the U.S. instances of outside director personal liability we found occurred at insolvent firms. One problematic scenario arises when outside directors either have no insurance or the insurance they have is inadequate to cover their litigation expenses through trial. Under these circumstances, the directors will likely incur out-of-pocket expenses by going to trial, regardless of the merits of the case. Consequently, even directors convinced they have done nothing wrong may conclude that they will do better by settling for an out-of-pocket payment than by trying the case and winning, let alone taking the risk of losing.

Four of the eight 1980–2005 securities lawsuits in which outside directors made out-of-pocket payments fit this low-or-no-insurance "Can't Afford to Win"

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460. *In re The Walt Disney Co. Derivative Litigation*, 907 A.2nd 693 Del. Ch. 2005), affirmed by the Delaware Supreme Court, 906 A.2nd.27 (2006).

461. See id at page 752 ("The vast majority of Delaware corporations have a provision in their certificate of incorporation that permits exculpation to the extent provided for by § 102(b)(7) [of Delaware's corporate legislation]."). On the relevant legislative provisions, see the supporting commentary for Model Business Corporation Act Annotated § 2.02 (2002), the Model Business Corporation Act (MBCA) provision authorizing corporations to limit or eliminate the personal liability of a director.

462. *See* 2 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 22-12 (7th edition, 2005) ("Contracts, bylaws or charter provisions frequently provide for indemnification 'to the fullest extent permitted by law'.").

pattern; a fifth might do so.[463] However, this scenario should not be a substantial concern for outside directors today, assuming a public company has a well-counseled board. Virtually all U.S. public companies now carry D&O insurance, and the vast majority have insurance at levels that should cover litigation expenses with enough left over to fund a decent settlement. Furthermore, companies can now purchase insurance designed to preserve outside directors' coverage irrespective of misconduct that will permit insurers to deny coverage to the inside directors.

With an insolvent company that has D&O coverage sufficient to cover legal expenses and fund a decent settlement, settlements are likely to occur within the D&O policy limits and leave directors' personal assets intact. Plaintiffs will accept such terms to avoid the risk and expense of going to trial and to ensure that the proceeds of the D&O policy—often the sole remaining "deep pocket"—are not depleted by directors' legal expenses. This settlement dynamic, however, is not inevitable. For securities lawsuits, which are the primary source of risk for outside directors of U.S. public companies, a plaintiff can, in a "Perfect Storm" scenario, credibly threaten to go to trial and collect damages from the outside directors personally that might bankrupt them. In response, the outside directors should be willing to settle by making out-of-pocket payments that are less than their expected loss if they were to go to trial.[464]

For outside directors, in simplified form, the elements of a Perfect Storm are: (i) the company is insolvent and the D&O insurance available to cover all directors is less than the lead plaintiff's estimate of the net present value of going to trial; (ii) the case against the outside directors involves either a claim for prospectus misdisclosure under § 11 of Securities Act of 1934, for which the operative standard is negligence, or an unusually strong claim based on disclosures outside the public offering context, which involve a higher "scienter" standard of culpability; and (iii) there must be defendants with sufficient wealth, aligned with culpability, so that the plaintiffs can expect to recover more by going to trial than by settling within policy limits.[465] Four (possibly five) of the securities lawsuits where outside directors made personal payments between 1980 and 2005 were Perfect Storms or came close to being so, including Enron and WorldCom.

With Enron and WorldCom, an additional element of the settlements captured attention. In both instances, a public-minded plaintiff made it a priority to collect directly from the outside directors so as to send a message to future boards. In the WorldCom settlement, the New York State Common Retirement Fund, as lead plaintiff, insisted that the outside directors pay some damages out of their own

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463. On the actual cases and for a broader examination of the "Can't Afford to Win" scenario, see Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STANFORD LAW REVIEW 1055-1159 (2006), at 1109-1110.

464. On the "Perfect Storm" scenario, see *id.* at 1113-1118.

465 It is not necessary that the outside directors themselves be wealthy. Plaintiffs may choose to keep them in a case, perhaps at relatively little extra cost, where the primary recovery would come from other defendants.

pocket in order to send "a strong message to the directors of every publicly traded company that they must be vigilant guardians for the shareholders they represent."[466] The Enron settlement likely reflected a similar motive on the part of the lead plaintiff, The Regents of the University of California, although plaintiffs' counsel was more vocal than the lead plaintiff in so stating the objectives.[467]

The Enron and WorldCom securities fraud settlements were quickly heralded as "legendary."[468] John Coffee, a Columbia law professor, said the "explicit agenda of requiring a personal contribution ha[d] traumatized outside directors."[469] It is doubtful, however, whether future lead plaintiffs will be able to adopt successfully the negotiating stance of the Enron and WorldCom lead plaintiffs unless conditions approaching a Perfect Storm are present. To illustrate, a "send a message" strategy is only likely to be feasible if the company is insolvent. In a securities case, the company is primarily liable for all damages, and the case is easier to prove against the company than against outside directors.[470] Moreover, a company is usually bound to indemnify the outside directors for any damages they might be liable to pay. Assuming a company offers to pay damages in full in a settlement or after a trial, a lead plaintiff will be hard pressed to justify prolonging the case by demanding that outside directors be held partly accountable, particularly since lead plaintiffs owe duties to act in the interests of the class.

Even if public pension funds or other institutional investors were to seek out-of-pocket payments from outside directors with some frequency, a market or political counter-reaction could restore the status quo. When concerns about directors' legal risks have emerged in the past in the U.S., legal and market responses have brought the risk down again. The rise of securities fraud lawsuits in the 1960s fostered the liberalization of indemnification rules under corporate law and the widespread purchasing of D&O insurance.[471] Also noteworthy was the legislative response to the famous *Smith v. Van Gorkom* case, in which the Delaware Supreme Court ruled that outside directors had failed to use sufficient care in approving a merger and awarded damages in excess of the D&O insurance

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466. Press Release, Office of the New York State Comptroller, Hevesi Announces Historic Settlement, Former WorldCom Dirs. to Pay from Own Pockets (Jan. 7, 2005).

467. *See* Ben White, *Former Directors Agree to Settle Class Actions; Enron, WorldCom Officials to Pay Out of Pocket*, WASHINGTON POST, Jan. 8, 2005, at E1 (quoting plaintiffs' counsel, William Lerach, saying the settlement will "send a message").

468. Roger Eabee, *Director Shortage? No Way*, FINANCIAL EXECUTIVE, May 2005, at 38.

469. John C. Coffee, Jr., *Hidden Issues in 'WorldCom',* NATIONAL LAW JOURNAL, Mar. 21, 2005, at 13.

470. *See* Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STANFORD LAW REVIEW 1055-1159 (2006), at 1080-1081.

471. We discuss the tendency for there to be a political reaction to the risk of personal liability in Bernard S. Black, Brian R. Cheffins & Michael Klausner, *Liability Risk for Outside Directors: A Cross-Border Analysis*, 11 EUROPEAN FINANCIAL MANAGEMENT 153-171 (2005), at 161.

coverage.[472] Delaware and state legislatures nationwide enacted statutes that permitted companies to amend their charters to protect outside directors from liability for breach of the duty of care. The efforts to reduce director exposure in the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998 offer further examples of a legislative reaction to fears of director liability.[473] Should outside directors begin to face serious liability risks in the wake of the WorldCom and Enron settlements, a similar legislative correction might well occur.

Multi-Country Overview

Cheffins and Black also study the practical extent of outside director liability in Australia, Canada, France, Germany, Japan, and the U.K. All of these countries, except for Australia, are surveyed in this Report. They summarize their results as follows. Only selected footnotes are included in this excerpt, and deletions and small stylistic changes are not marked.[474]

> From an American perspective, our comparative analysis shows that the United States is exceptional in its level of litigation. Lawsuits involving directors are less common in other countries because losing litigants are often required to pay at least part of the successful party's legal expenses, because lawyers cannot claim attorneys' fees in derivative litigation, because U.S.-style contingency fees are not permitted and because class actions are difficult to launch. There are, however, various key common themes across borders:
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> (i) Outside directors of public companies face only a remote chance of paying out of their own pocket for oversight failures;
>
> (ii) That risk exists primarily when the company has suffered an acute financial crisis, often leading to bankruptcy;
>
> (iii) Lack of protection by D&O insurance (including low policy limits and policy exclusions) can be an important risk factor;
>
> (iv) The "send a message" scenario does pose dangers for outside directors, but often it is regulators rather than private litigants who are seeking to make a point; and
>
> (v) Political and market reactions often emerge to reduce the risk of out-of-pocket payments, when it arises.

472. 488 A.2nd 858, 864 (Delaware Supreme Court, 1985). The acquirer paid the judgment in excess of available D&O coverage on behalf of the outside directors but required each director to donate 10% of this amount to charity. *See Roundtable Discussion: Corporate Governance*, 77 CHICAGO-KENT LAW REVIEW, 235 (2001), at 238 (quoting Robert Pritzker, a controlling shareholder of the acquiring company).

473. See ROBERT W. HAMILTON, THE LAW OF CORPORATIONS IN A NUTSHELL 562-564 (5th edition 2000) (summarizing the key aspects of these two Acts).

474 Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEXAS LAW REVIEW 1385-1480 (2006), at 1399, 1475-1477.

This paper has identified a pervasive cross-border trend: outside directors of public corporations are unlikely to have to pay damages or analogous financial penalties out of their own pocket for failures of oversight. We have made these points by considering the situation in six countries (Australia, Canada, France, Germany, Japan, and the United Kingdom) and by drawing on research we have done on the United States.

Though liability for self-dealing, including insider trading, is beyond this article's scope, it is clear that outside directors are at risk if they act in a self-serving or dishonest fashion. The penalties imposed on Rodney Adler (of HIH) and Stephen Vizard (Telstra) illustrate this. Self-dealing aside, the risk is tiny, but not zero, in each country we have studied. Exposure to liability under U.S. securities law is, for example, one source of potential concern. Two instances of out-of-pocket liability we uncovered as part of our investigation of outside director liability in the U.S. involved companies cross-listed in the U.S. (Independent Energy Holdings and the confidential Canadian out-of-pocket payment). Nevertheless, given that U.S. outside directors rarely make personal payments in securities litigation, the risks faced by outside directors of cross-listed companies should be small, particularly if the companies purchase D&O insurance that meets current U.S. norms.

Our study suggests the primary source of risk in fact is where the party in control of a lawsuit—often the government—is prepared to look beyond the financial costs and benefits of seeking recovery in the immediate case and treats extraction of a personal payment from the outside directors as a priority, often in order to send a message to other boards. How often is this situation likely to arise? Our survey suggests the answer is not very often.

Instances where outside directors of public companies have agreed to pay damages or a related financial penalty out of their own pockets discussed in this paper have most often involved a prominent company suffering a massive financial reversal (e.g., Enron, WorldCom, the two failed Canadian banks, HIH, One.Tel, and Clifford Corporation in Australia). When these ingredients are present, those controlling the litigation may be able to "make a statement" by securing an out-of-pocket payment from directors. Still, spectacular corporate collapses are the exception, not the rule, so this sort of opportunity is only likely to present itself on isolated occasions.

Even with a high-profile corporate meltdown, private parties suing those allegedly responsible will normally seek to maximize their expected recovery, making due adjustments for time, risk, and expense. This will usually mean focusing on deep pockets (including D&O insurance) and not seeking personal payments from non-executive directors. In the U.S., as the Enron and WorldCom settlements indicate, public pension funds are potential candidates to "send a message" to outside directors, since those making the litigation decisions can benefit politically from taking a tough stance. This sort of "public-minded" and litigious investor is, however, uniquely American. Other countries lack private investors likely to treat the extraction of personal payments from outside directors as a priority.

> Outside directors of a public company that collapses in a highly publicized manner do face a meaningful risk of personal liability as a result of enforcement by government regulators. The handful of instances identified in this survey in which inattentive outside directors have paid out of their own pockets indicates this. Nevertheless, even non-executives whose inattentiveness was a contributing factor to a major corporate collapse may escape liability since regulators may focus exclusively on more culpable parties (e.g., the executives) or only seek sanctions with no direct financial penalty involved (e.g., disqualification). Even if we have underestimated the current degree of financial risk that outside directors face, our assessment of the "bottom line" might well still end up being correct. In the litigious United States, when concerns about directors' liability have emerged periodically in the past, legal and market reactions have brought the risk down again. Recent legislative reforms in Britain, Canada, Germany, and Japan suggest the same pattern is at work elsewhere, as does the rise of D&O insurance in all of the countries we have considered. These dynamics give reason to expect that the current equilibrium of very low out-of-pocket liability risk is likely to be restored after future shocks, whatever their source may be.

These authors separately studied Korea and reached similar conclusions.[475]

Summary

This chapter provides an overview of practical experience with the liability of directors in other countries. There are no specific recommendations which follow directly from this chapter. However, the practical experience in other countries illustrates some of the difficulties that Russia is likely to face in fostering a realistic possibility for directors to face liability for breach of duty to the company.

This experience underscores the importance of the rules of civil procedure, especially those related to payment of legal expenses. Even well-drafted substantive rules, contained in the company law, will often be rarely used if procedural rules discourage shareholder suits.

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475. Bernard S. Black, Brian R. Cheffins & Michael Klausner, *Shareholder Suits and Outside Director Liability: The Case of Korea*, in CORPORATE GOVERNANCE AND THE CAPITAL MARKET IN KOREA (Young-Jae Lim editor, 2006), *at* http://ssrn.com/abstract=628223.

Chapter 12. Administrative liability of directors and managers

Subchapter 12.1 Administrative offences of directors and managers

Issue: Should legislation establish administrative liability of members of a company's management organs (managers and directors) for breach of duty to the company, established by company law? If yes, what is the description of these offenses? That is, what breaches of duty should give rise to administrative offences? This includes the following more specific questions:

- *Should there be administrative liability for breach of fiduciary duty involving a conflict of interest?*
- *Should there be administrative liability for breach of fiduciary duty not involving a conflict of interest?*
- *Should there be administrative liability for breach of fiduciary duty involving a failure of disclosure?*
- *Should there be other circumstances in which members of management organs face administrative liability for breaches of duty under company law?*

Russian context

Administrative liability of persons who are members of a company's management organs is provided for by the Code of Administrative Offenses and laws on administrative offenses established by constituent entities of the Russian Federation. These local laws must not contradict the Code of Administrative Offenses. Amendments to the Code of Administrative Offenses which went into effect in 2006 excluded some previously available instances of administrative liability of members of a company's management organs. In particular, articles were excluded from the Code which provided the following:

> 1) *liability for improper management of a legal entity* (former Code of Administrative Offenses art. 14.21). In practice, however, this liability was found extremely rarely. The primary problem in applying administrative liability lay in the difficulties of proving losses and proving a cause-and-effect connection between the company's losses and the specific actions of a person. In addition, no criterion existed in the legislation which the court could use in determining what penalty to apply.
>
> *2) liability for conducting transactions and committing other actions going beyond the person's authority* (former Code of Administrative Offenses art. 14.22).

These two articles were excluded from the Code of Administrative Offenses because of the perceived inexpediency and redundancy of State intervention in the operations of economic entities. Members of a company's management organs, if their actions cause losses to a legal entity, already face liability under civil law and labor law, and so a public method for regulating this problem was considered to be not needed.[476]

At the same time, there are several sources of administrative liability for members of management organs of legal entities that remain in force in the Code of Administrative Offenses. All involve bankruptcy directly or indirectly.

Offense	**Constituent elements**	**Penalty**
intentional bankruptcy (art. 14.12(2))	commission by the manager or founder of a legal entity of actions/nonfeasance knowingly resulting in the bankruptcy of the legal entity, if these actions/nonfeasance do not constitute a crime.	fine of 50-100 times the minimum monthly wage disqualification for 1-3 years
wrongful actions when going bankrupt (art. 14.13)	wrongful actions when going bankrupt include the following, if committed when foreseeing bankruptcy and not criminally punishable: - concealing or falsifying property, information about property; and accounting and other records; - wrongful payments to individual creditors, knowingly resulting in harm to other creditors; - obstructing the activities of the insolvency officer; - failure to file for bankruptcy in the cases provided for by the Bankruptcy Law.	fine of 50-100 times the minimum monthly wage disqualification for 6 months-2 years
management of legal entity by disqualified person (art. 14.23(1))	disqualification is an administrative punishment which revokes a person's right to (a) be a member of the management organ of a legal entity, (b) carry out entrepreneurial activities involving managing a legal entity, (d) manage a legal entity in the other cases provided for by Russian legislation.	fine of 50 times the minimum monthly wage for a physical person, or 1,000 times for a legal entity

There is no legislative statement on which persons can file a petition seeking a manager's disqualification. Thus, not only the State but any legal or physical person, such as a shareholder, can initiate this action.

The Code of Administrative Offenses also codifies the administrative liability of members of a company's management organs for offenses in the area of the securities market. Fines for offenses in this area are determined by the Federal Service on the Financial Market or its regional division (Code of Administrative Offenses, art. 23.47). These offenses include: bad-faith issuing of securities (Code of Administrative Offenses

476 Explanatory note to the Draft of the Federal Law "On Amending the Code of Administrative Offenses of the Russian Federation" (Draft No. 159101-4) (Пояснительная записка к Проекту Федерального закона «О внесении изменений в кодекс Российской Федерации об административных правонарушениях» (Проект № 159101-4)).

art. 15.17), violation of legal requirements for submission and disclosure of information (Code of Administrative Offenses art. 15.19) violating shareholder rights, for example by not providing notice of the date of a general shareholder meeting (Code of Administrative Offenses art. 15.20), and failure to maintain a share registry (Code of Administrative Offenses art. 15.22).

Draft amendments to the Code of Administrative Offenses would introduce new administrative offenses for violating the procedure for calling and conducting a general shareholder meeting and posting the results of the general shareholder meeting.[477]

Canada

There is no scope for the public officials in charge of administering corporate legislation – referred to collectively as "the Director" under the CBCA and the OBCA – to establish administrative liability for misconduct amounting to a breach of a duty by directors.

France

The Code de Commerce does not contain any administrative sanctions itself. However, some violations of the Code de Commerce concerning failure of disclosure can lead to administrative liability.

In two cases the starting point is the Code de Commerce itself. (1) According to Article L. 225-212, a company has to inform the Financial Markets Authority about a plan for the company to acquire its own shares, once the repurchase of shares has been authorized by a general shareholder meeting. (2) According to Articles L. 233-8 and L. 223-11, a listed company has to inform the Financial Markets Authority if "the number of voting rights changes" or "if there is an agreement which allows preferential terms and conditions to be applied to the sale and purchase of shares". These provisions apply only to groups of companies, namely "when a company owns more than half of the capital of another company …)" (Article L. 233-1).

Furthermore, the *Code monétaire et financier*[478] frequently refers to disclosure provisions of the Code de Commerce (in particular, with regard to initial public offerings). Thus, violation of these provisions can lead to the applicability of administrative sanctions under securities law.

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477 Draft of the Federal Law "On Amending the Code of Administrative Offenses of the Russian Federation with Regard to Increasing Administrative Liability for the Violation of the Legislation of the Russian Federation on Joint-Stock Companies, on Limited Liability Companies, on the Securities Market, and on Investment Funds and the Federal Law 'On the Securities Market' with Regard to the Specification of the Definition and Features of Manipulation on the Securities Market" (Draft No. 414167-4) (Проект Федерального закона «О внесении изменений в Кодекс Российской Федерации об административных правонарушениях в части усиления административной ответственности за нарушения законодательства Российской Федерации об акционерных обществах, об обществах с ограниченной ответственностью, о рынке ценных бумаг и об инвестиционных фондах и Федеральный закон «О рынке ценных бумаг» в части уточнения определения и признаков манипулирования на рынке ценных бумаг» (Проект N 414167-4)).

478 English version at http://195.83.177.9/code/liste.phtml?lang=ukandc=25.

In all these cases the Financial Markets Authority can impose penalties and fines on directors (Code monétaire et financier, art. L. 621-15). However, none are directly concerned with breach of duty to the company under company law.

Germany

AktG §§ 405, 406 provide for sanctions known as *Ordnungswidrigkeiten*. The enforcement of these *Ordnungswidrigkeiten* has some similarities to criminal and some to administrative procedure (see Issue 13.2 below). Thus, it is difficult to classify them as either an administrative or a criminal sanction. This can also be seen in the English translation of the AktG, where sometimes they are translated as "administrative offences" and sometimes as "misdemeanors." For convenience, we treat these sanctions in this Report as administrative in nature.

AktG § 405 addresses the administrative liability of directors and shareholders. With respect to directors, the provision addresses mainly the issuance of shares and restrictions on repurchases of shares. Furthermore, directors are liable, according to AktG § 406, if they violate AktG § 71(3) (¶ 3). This violation will arise if the directors do not inform the Financial Markets Authority about an authorisation by a general meeting of shareholders for the company to acquire its own shares.

Directors may also potentially have to pay a *Zwangsgeld* ("enforcement fine") under AktG § 407. However, this should not be regarded as administrative *liability*. The purpose of this fine is to ensure that the directors comply with company-law requirements *ex ante* (e.g. to provide required information to the commercial registrar) and not to provide a sanction *ex post* for breach of duty.

Korea

There are no administrative sanctions for violation of the company law provisions of the KCC.

If a public company violates the KSEA, which contains corporate governance-related provisions for public companies, the Korea Financial Supervisory Commission may recommend that the shareholders' meeting of such company discharge the directors and officers concerned. The Commission may also restrict the issuance of securities for a fixed period of time or take other measures prescribed by the Presidential Decree which accompanies the KSEA (KSEA art. 193). These sanctions are applied against the company. There are no administrative sanctions that can be imposed against individual directors.

United Kingdom

There is no scope for the public officials in charge of administering corporate legislation to impose establish administrative penalties for misconduct amounting to a breach of a duty by directors.

There is some scope, in contrast, for administrative penalties under securities law. The Financial Services Authority, which administers the Financial Services and Markets Act 2000, is authorized by that Act to impose administrative penalties on directors of publicly quoted companies who breach obligations imposed by that Act. These administrative penalties are beyond the scope of this Report, but texts on U.K. securities regulation provide helpful overviews of the topic.[479]

United States

There is no administrator with the power to enforce duties under corporate law, and therefore the issue of administrative penalties does not arise.

However, some aspects of what might be considered to be company law are addressed by U.S. securities law, and the Securities and Exchange Commission, has the power to petition a court to impose fines for violations, and to bar a director or officer from serving as a director of a public company.

The administrative power of the SEC, as applied to outside directors, is discussed in a recent article by Black, Cheffins, and Klausner, as follows. The SEC also has power to enforce insider trading rules through administrative penalties, but we treat insider trading as outside the scope of this Report:[480]

> Federal securities law authorizes the SEC to petition a court to impose monetary penalties on any person who violates the securities laws and to order disgorgement of illegal profits.[481] To check for instances in which outside directors paid penalties or disgorged profits, we relied on: (1) the survey and legal database searches described in Part I and Appendix A, (2) additional searches of SEC litigation releases, and (3) interviews with current and former SEC officials and with lawyers who represent defendants in SEC proceedings. We did not uncover a single instance where SEC enforcement has yielded a civil penalty against an outside director for oversight lapses.[482]
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> At the same time, SEC officials have publicly stated that a number of ongoing

479 See, for example, ENCYCLOPEDIA OF FINANCIAL SERVICES LAW (Eva Lomnicka & John L. Powell editors, 2004) (looseleaf publication).

480 Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STANFORD LAW REVIEW 1055-1159 (2006), at 1131-1135 (only selected footnotes are included in this excerpt).

481. *See* 15 U.S.C. § 78u-2(a) (2006) (describing the authority of the SEC to seek civil penalties); *see also* Anish Vashista, David R. Johnson & Muhtashem S. Choudhury, *Securities Fraud*, 42 AMERICAN CRIMINAL LAW REVIEW 877-941 (2005), at page 927.

482. In *SEC v. Excal Enterprises*, SEC Litigation Release No. 14,651, 1995 SEC Lexis 2492 (Sept. 26, 1995), Charles Ross was listed as a "former outside director" and paid a civil penalty of $50,000 to settle SEC proceedings alleging active participation in the preparation of false reports and lying to auditors. Ross, however, was not a true outside director because he was a senior executive for one of the company's divisions.

SEC investigations include outside directors.[483] According to press reports, the SEC has notified three individuals who served on the audit committee of publisher Hollinger International of its intention to pursue civil proceedings. Civil penalties are a possible sanction in these cases, but whether the SEC will seek them is as yet unknown.

If an outside director pays a civil penalty, the director cannot count on being reimbursed by the usual sources because the SEC currently insists, as a condition for settling an action seeking such a penalty, that the penalty be paid personally, even if indemnification or D&O insurance would otherwise be available. On the other hand, the SEC, when it has settled actions seeking civil penalties from insiders, has not objected to reimbursement for legal expenses.

While some SEC actions seeking penalties against outside directors for oversight failure are certainly possible, it seems unlikely that the SEC will begin to seek such penalties very often. The SEC likely recognizes—and if need be, market participants will be vigorous in reminding it—that it may deter qualified individuals from serving if it acts too aggressively against directors in cases involving oversight failure, as opposed to self-dealing. A further important protection for outside directors is that the dollar limits on civil penalties remain fairly low. The maximum likely exposure is $100,000 per offense.[484] This is low enough that, for many directors, the risk of loss will be primarily reputational rather than financial.

The SEC, in addition to seeking monetary penalties and disgorgement of profits, can bar a director who has committed securities fraud from serving as an officer or director of a public company. The statutory standard for such an order is that "the person's conduct demonstrates unfitness to serve as an officer or director of [a public company]."[485] For the SEC to show unfitness, it must demonstrate a

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483. *See* Remarks by Alan Beller, Head of SEC's Division of Corporation Finance, American Bar Association Webcast (Dec. 14, 2005), at http://www.connectlive.com/events/secadvisory_1205/. Several interviewees also told us about these investigations.

484. The maximum civil penalty depends on the nature of the crime and the potential for harm resulting from the actions. The highest category of fines is for a violation involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement," which results in a "significant risk of substantial losses . . . to other persons." The maximum fine for this category is the greater of $100,000 per offense or the director's pecuniary gain as a result of the violation. An outside director usually will not have a pecuniary gain. Securities Act § 20(d)(2)(C), 15 U.S.C. § 77t(d)(2)(C) (2006); Exchange Act § 21(d)(3)(B)(iii), 15 U.S.C. § 78u(d)(3)(B)(iii) (2006).

485. Until 2002, the SEC needed a court order to impose such a bar. Securities Act § 20(e), 15 U.S.C. § 77t(e) (2006); Exchange Act § 21(d)(2), 15 U.S.C. § 78u(d)(2) (2006). The Sarbanes-Oxley Act, enacted in 2002, allows the SEC to impose this sanction in an administrative cease-and-desist proceeding, subject to appeal to a court of appeals. *See* Securities Act § 8A(f), 15 U.S.C. § 77h-1(f) (2006); Exchange Act § 21C(f), 15 U.S.C. § 78u-3(f) (2006) (added by Sarbanes-Oxley Act § 1105). The judicial review provisions are in Securities Act § 9(a), 15 U.S.C. § 77i (a) (2006), and Exchange Act § 25(a), 15 U.S.C. § 78y(a) (2006). The SEC has not yet used this administrative power.

In lieu of seeking formal sanctions, the SEC has occasionally issued reports concluding that outside directors did not meet their obligations under the securities laws. These reports are exercises in public shaming and do not involve financial sanctions. For the most recent examples of such reports, see Report likelihood that the misconduct will be repeated.[486] In the absence of self-dealing or an extraordinary lapse in oversight, this threshold is difficult to meet.

The high threshold likely explains why we have found only one case in which the SEC has sought to bar an outside director from serving as an officer or director based on an oversight failure. This instance involved Rudolph Peselman, an outside director of Chancellor Corp., a company afflicted by fraudulent accounting. In 2005, Peselman settled SEC proceedings by agreeing to a permanent bar from serving as a director or officer of a public company.[487]

In sum, while careless or incompetent outside directors face theoretical financial risk due to SEC enforcement, they have had little to fear up to this point in time. Moreover, while future SEC actions seeking penalties against inattentive outside directors are certainly possible, it seems likely that directors' future risk will continue to be principally loss of reputation rather than direct financial loss.

Black, Cheffins and Klausner's description of the available sanctions also applies to executives. However, their discussion of the rarity of actual proceedings seeking administrative sanctions addresses only the experience of outside directors. The SEC pursues actions against executives with some frequency.

Summary and recommendations

Among the comparison countries, the norm is for there not to be administrative penalties for breach of duty owed to the company under company law. We also understand that in Russia, there was formerly a possibility for these sanctions, which was recently removed by legislation. In subchapter 12.2, we provide a table which summarizes the powers provided to financial regulators and prosecutors, with respect to bringing a civil action on behalf of shareholders, seeking administrative penalties, and seeking criminal sanctions.

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of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace and Co., Exchange Act Release No. 34-39157, 1997 WL. 597984 (Sept. 30, 1997) (criticizing the conduct of outside directors Eben Pyne and Charles Erhart); In the Matter of W.R. Grace and Co., Order Instituting Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 Making Findings and Ordering Respondent To Cease and Desist, Exchange Act Release No. 34-39156, 1997 WL. 600685 (Sept. 30, 1997) (finding that the company failed to adequately disclose retirement benefits received by former CEO J. Peter Grace, Jr., as well as a proposed transaction between the company and J. Peter Grace III); Report of Investigation in the Matter of the Cooper Companies, Inc. as It Relates to the Conduct of Cooper's Board of Directors, Exchange Act Release No. 34-35082, 1994 WL. 707149 (Dec. 12, 1994) (criticizing Cooper's Board of Directors for not responding vigorously to the evidence that officers had engaged in several fraudulent schemes).

486. *See* SEC v. Patel, 61 F.3d 137, 141-42 (2nd Cir. 1995) (reversing district court's approval of the lifetime director-officer ban against an officer-director-founder because the district court did not explain why repeat violations were likely without the ban); *see also* Jayne W. Barnard, *When Is a Corporate Executive "Substantially Unfit To Serve"?*, 70 NORTH CAROLINA LAW REVIEW 1489-1522 (1992).

487. *See* SEC v. Chancellor Corp., SEC Litigation Release No. 19,177, 2005 SEC Lexis 800 (Apr. 11, 2005) (announcing settlement); SEC v. Adley, SEC Litig. Release No. 18,104 (Apr. 24, 2003) (announcing initiation of proceedings), at http://www.sec.gov/litigation/lit releases/lr18104.htm. For citations to officer-director bar cases against *insiders*, see 10 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION §§ 5087-5092 (3rd edition, 1989).

We recommend that the FSFM should not have the power to levy administrative penalties for breach of duty under company law. The comparative experience, the recent legislative judgment that there was concern with providing this power to the FSFM, and general concerns over the extent to which government officials can be relied on to act impartially all counsel against providing this additional power, at least at the present time.

Subchapter 12.2 Procedural aspects of administrative liability of members of company management organs

Issue: What powers should the federal executive body on financial markets have in the process of bringing to administrative liability of said persons?

This includes the following more specific questions:

- *Should the regulator of financial markets have investigative powers, including the power to obtain documents and to compel testimony?*
- *Can the regulator assess civil penalties, to be paid to the government? If so, in what amounts?*
- *If the regulator can assess civil penalties, is there a right to appeal the regulator's decision to court?*
- *Can the regulator bar a director or manager from serving as a director or manager of this or other companies?*
- *Can the regulator enjoin future violations of the law? If so, what are the consequences if the injunction is not obeyed?*

Russian context

Under Code of Administrative Offenses art. 14.12 (liability for intentional bankruptcy) and art. 14.23 (liability for the management of a legal entity by a disqualified person), reports on administrative offenses are compiled by law enforcement officers (police) (Code of Administrative Offenses art. 28.3(2(1))). A hearing is held, and fines imposed, by the arbitrazh courts (Code of Administrative Offenses art. 23.1(3)). These violations are examined without the participation of the Federal Service on the Financial Market. Some scholars believe that the FSFM should be able to participate, at least for a company which has issued securities to the public.

The FSFM is, nevertheless, authorized to compile reports on administrative offenses in the area of the securities market and can impose fines for these offenses. Moreover, the FSFM has the right to conduct audits of companies in order to detect and prevent offenses on the securities market.[488]. Upon discovering administrative offenses, the FSFM compiles a report (Code of Administrative Offenses art. 28.5) and must examine the case within 15 days (Code of Administrative Offenses art. 29.6). No court hearing is provided for examining disputes in these cases.

488 The procedure for conducting audits of organizations is established by an FSFM regulation. Order of the Federal Service on the Financial Market of the Russian Federation, No. 05-16/pz-n "*On the Affirmation of the Procedure for Conducting Audits of Organizations, the Control and Oversight of Which Are Imposed upon the Federal Financial Markets Service*" (Apr. 20, 2005, as amended on Dec. 12, 2005) (Приказ Федеральной Службы по Финансовым Рынкам Российской Федерации от 20.04.2005 № 05-16/пз-н (ред. от 22.12.2005) *«Об утверждении порядка проведения проверок организаций, осуществление контроля и надзора за которыми возложено на Федеральную Службу по Финансовым Рынкам»).*

Canada

Since there is no scope for the officials administering corporate legislation to establish administrative liability, these questions are moot.

Under most provincial securities laws securities administrators are given the power to make a wide range of orders to encourage compliance with securities legislation. Administrative penalties under securities legislation are beyond the scope of the current enquiry, but texts on Canadian securities regulation provide helpful overviews of the topic.[489]

France

The French regulator of financial markets is the AMF (*Autorité des Marchés Financiers*, or Financial Markets Authority). The responsibilities and powers of the AMF is governed by a these authorities are governed by special laws, the *Code monétaire et financier* and the *Règlement général de l'Autorité des marchés financiers*. In general, issues of company law do not lie within the responsibility of these authorities. For instance, Article L. 621-1 of the Code monétaire et financier states that the AMF "deals with the protection of the savings invested in financial instruments and all other investments which give rise to public offerings, the information provided to investors, and the proper functioning of the financial instruments markets."

For matters within its jurisdiction, the AMF has the power to carry out inspections and investigations and to issue orders (Code monétaire et financier, art. L. 621-9), and can also impose financial penalties and fines (see, e.g., Code monétaire et financier, art. L. 621-15).

With respect to a violation of Article L. 225-212 (discussed in chapter 12.1 above, concerning failure to provide information about the company's acquisition of its own shares) the Financial Markets Authority may request the company "to provide any explanation or proof in this regard which it considers necessary. If such requests are not complied with, or if it finds that a violation of Article L. 225-209 (which contains the substantive rules governing a company's acquisition of its own shares), the Financial Markets Authority may take all necessary measures to prevent the completion of orders to acquire shares made directly or indirectly on behalf of the company.

With respect to a violation of Code de Commerce arts. L. 233-8 and L. 223-11 (discussed in chapter 12.1 above: concerning failure to provide information about changes involving a group of companies), the Code de Commerce is silent on administrative penalties. However, Article L. 451-2 of the Code monétaire et financier reproduces Articles L. 233-7 to L. 233-14 of the Code de Commerce. Thus, in effect, the powers that the Code monétaire et financier grants to the Financial Markets Authority apply to these provisions of the Code de Commerce.

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489 See, for example, MARK R. GILLEN, SECURITIES REGULATION IN CANADA (2nd edition, 1998), at 503-511.

Administrative penalties under securities law

Similarly, for cases in which the Code monétaire et financier refers to disclosure provisions of the Code de Commerce (in particular, regarding initial public offerings of shares) (see the discussion in subchapter 12.1 above), the general provisions of French securities law are applicable, and give administrative powers to the Financial Markets Authority. These provisions include: Code monétaire et financier art. L. 621-9 (power to carry out inspections and investigations); art. L. 621-10 (request sight of any document), art. L. 621-18 (request to provide information).

For the Financial Markets Authority to pursue instances of insider dealing (Code monétaire et financier arts. L. 465-1, 465-2), judicial authorisation is necessary (art. L. 621-12).

Under Code monétaire et financier, art. L. 621-15(3):

> "The penalties for violation of these provisions are:
>
> > a) For the persons referred to in . . . Article L. 621-9, a warning, a reprimand, or temporary or permanent prohibition from providing some or all of the services offered; the disciplinary committee may pronounce, either instead of, or in addition to, those penalties, a financial penalty of an amount not exceeding 1.5 million euros or ten times the amount of any profit realised;
> >
> > b) For natural persons placed under the authority of, or acting on behalf of, a person referred to in . . . Article L. 621-9, a warning, a reprimand, temporary or permanent withdrawal of their professional card, temporary or permanent prohibition from engaging in some or all of their activities; the disciplinary committee may pronounce, either instead of, or in addition to, those penalties, a financial penalty of an amount not exceeding 1.5 million euros or ten times the amount of any profit realised in the case of [certain] practises [and] 300,000 euros or five times the amount of any profit realised in other cases;
> >
> > c) For [other] persons, a financial penalty of an amount not exceeding 1.5 million euros or ten times the amount of any profit realised.
>
> The amount of the penalty must be commensurate with the seriousness of the breaches committed and any advantages or profits derived from those breaches."

The Financial Markets Authority only imposes penalties and does not initiate a claim for damages to be paid to shareholders.[490] A person who is found liable has the right to appeal to court.[491]

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490 An exception is Code monétaire et financier, Article L. 621-16-1, which provides: "When a prosecution is instituted pursuant to Articles L. 465-1 and L. 465-2 [these provisions concern insider dealing], the Financial Markets Authority may bring an independent action for damages. However, it cannot, with regard to the same person and the same facts, both seek damages and exercise its disciplinary powers.

491 For the complicated issues regarding the proper procedure see Nicole Decoopman, *Autorité des Marchés Financiers – Pouvoir de sanction,* JURIS CLASSEUR SOCIETES TRAITE Fasc. 1511 (2004).

The Financial Markets Authority does not have the power to disqualify directors from serving in this capacity. It also does not have the power to enjoin future violations of the law.

Germany

The German regulator of financial markets is the BaFIN (*Bundesanstalt für Finanzdienstleistungsaufsicht*), or Federal Financial Supervisory Authority. The responsibilities and powers of the BaFIN are governed by special laws, the *FinDAG* (Finanzdienstleistungsaufsichtsgesetz), or Act on Supervision of Financial Services (which establishes the BaFin), the *KWG* (Kreditwesengesetz), or Banking Act,[492] and the German Securities Trading Act (WpHG).[493] In general, issues of company law do not lie within the responsibility of the BaFIN. See, for example WpHG § 4(¶1) (giving authority over insider trading to BaFIN). For matters within its jurisdiction, the BaFIN has the power to carry out inspections and investigations and to issue orders (see, for example, WpHG § 4 (¶2). It can also impose financial penalties and fines (see, for example, WpHG § 39).

The only article of the company law for which the BaFIN has powers is AktG § 406, which was discussed in chapter 12.1 above, involving failure to provide information about a shareholder authorisation to the company to buy back its own shares). For this specific section, the BaFIN is the "responsible administrative agency" with respect to administrative liability (AktG § 406(3)).

The applicable law specifying the powers of an administrative agency, assuming it is the "responsible administrative agency" under a particular provision of law, is the "Regulatory Offences Act" (OWiG). OWiG § 46(2) states that, in general, the "responsible administrative agency" has the same powers as a public prosecutor under the "Code of Criminal Procedure" (StPO). In particular, the BaFIN has the powers provided by StPO § 94, which states that "objects which may have importance as evidence for the investigation shall be impounded or be secured in another manner" and StPO § 133, which states that "the accused shall be summoned in writing to the examination and that the summons may provide that the accused shall be brought before the court in the case of non-compliance." However, only a court can compel testimony (see OWiG § 46(5)).

The fine for a violation of AktG § 406 is up to €25,000 and is imposed by the BaFIN as the responsible regulatory authority (see OWiG § 35(2)). The fine can be appealed to court (OWiG § 67).

There is nothing in the law which would give the BaFIN the powers to require directors to pay damages to investors, to seek to disqualify a director from serving in this position, or to seek an injunction against future violations of the law.

492 A somewhat dated English translation is available at: http://www.iuscomp.org/gla/statutes/KWG.htm.

493 A current English translation can be found on the BaFIN home page at: http://www.bafin.de/gesetze/wphg_en.htm.

Korea

Company law

Since there is no regulator with administrative authority for the company law provisions of the KCC, these questions are moot.

Securities law

The KSEA contains a number of corporate governance-related provisions that affect public companies. If these provisions are violated, the Korea Financial Supervisory Commission may recommend that a general shareholder meeting of the company discharge the directors and officers who have committed the violations. It may also restrict the issuance of securities for a fixed period of time, and can take the additional measures specified in the Presidential Decree which accompanies the KSEA (KSEA art. 193).

United Kingdom

Since there is no scope for the officials administering corporate legislation to establish administrative liability, the foregoing questions are not relevant with respect to the U.K.

United States

Corporate law

Since there is no administrative agency with authority to enforce corporation law, these questions are not relevant.

Securities law

The penalties which can be imposed on officers and directors by the Securities and Exchange Commission for violation of securities law are discussed in subchapter 12.1.

Summary and recommendations

The recommendations in this subchapter largely derive from the recommendations we have made with respect to the power of the FSFM to bring a civil suit (subchapter 8.3), to seek administrative sanctions (subchapter 12.1 and this subchapter), and to seek criminal sanctions (chapter 13). The table below provides an overview of the powers of the financial regulator in all three of these areas. It is apparent from the table that in most of the comparison countries, the financial regulator has limited powers to enforce the duties of directors under company law.

Powers of Financial or Companies Regulator under Company Law

The table below summarizes the power of the regulator of financial markets or the regulator of companies (if one exists) to seek various remedies for breach of duty to the company by directors and managers. The table does not address the powers of the financial regulator or the prosecutor to seek does not address remedies for other violations of company law, such as improper dividends or repurchase of shares, or the power of the securities regulator to seek remedies for violations of securities law.

	Financial Regulator Can			**Prosecutor can Obtain Criminal Sanctions**[494]
Country	**Bring Civil Action for Damages**	**Seek Administrative Penalties**	**Seek Criminal Sanctions**	
Russia	no	no	no	abuse of official position
Canada	CBCA: X OBCA: no	no	no	CBCA: no OBCA: possible but unlikely
France	no	no	no	X
Germany	no	limited	no	X (breach of trust)
Korea	no	no	no	X
United Kingdom	no	no	no	no[495]
United States	no	no	no	no

Investigative powers

We recommend below that the FSFM should have the power to impose the administrative sanction of disqualification for directors and managers of public companies. We discuss in subchapter 8.3, but do not offer a recommendation on, whether the FSFM should have the power to bring a civil action against the directors or managers of a public company. We do not recommend that the FSFM have power to seek administrative penalties (see subchapter 12.1) or that it have the power to bring criminal proceedings (see chapter 13).

If the FSFM is to have enforcement powers, it must also have the power to investigate, to determine whether a violation of law has occurred. Also, even if the FSFM does not directly have the power to bring criminal proceedings, it may be appropriate to give the FSFM the power to investigate violations and refer appropriate cases to the prosecutor. This could be valuable because the investigation of breach of duty under company law requires specialized investigative skills and procedures, which many prosecutors may not be familiar with.

However, the scope of these investigative powers should be commensurate with the scope of the authority of the FSFM to bring civil actions and order disqualification. We recommend that the powers of the FSFM should be limited to public companies. We therefore also recommend that the FSFM should have power to investigate public companies, but not nonpublic companies.

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494 We discuss criminal sanctions in chapter 13.

495 As discussed in Chapter 13.1, the prosecutor has power to bring criminal actions under some provisions of the Companies Act, but not for breach of duty owed to the company. Criminal actions under any provisions of the Companies Act are rare.

We note that even the power to investigate is controversial in Russia at the present time. An official investigation can impose substantial costs on a company, even if the outcome is that proceedings are not brought. There are persons who believe that, in some instances, government investigations against companies are instigated by competitors, who are seeking to discourage competition. However, the FSFM already has, and must have, significant power to investigate public companies. As longs as its powers to investigate breach of duty under company law is limited to public companies, we see some potential benefit to providing this power, and little incremental risk.

Civil penalties

The experience of other countries shows that the regulator of financial markets usually does not have the power to enforce the company law. In Germany, where the regulator has some power to assess civil penalties, this power is exercised in accordance with general rules of administrative procedure. In countries where the financial regulator can levy civil penalties under other laws, including securities laws, this power is again usually exercised in accordance with general rules of administrative procedure.

We do not recommend that the FSFM have the general power to assess administrative penalties. If the FSFM is given this power, we believe that the penalties should be imposed by a court, on petition by the FSFM, rather than be imposed by the FSFM subject to a right of appeal to court.

If the FSFM has the power to directly assess administrative penalties, the penalty should be subject to review by a court. The court should make an independent evaluation of the facts, and not simply accept the judgment of the regulator if that judgment appears to the court to be reasonable.

Disqualification

We recommend that the sanctions available to the FSFM should include barring directors and managers of public companies, for a period of time or permanently, from serving as a director or manager of a public company, based on serious breach of duty to a public company. A similar remedy is available in a number of comparison countries, under different laws. Cheffins and Black summarize:[496]

> The disqualification sanction is available under bankruptcy law in the United Kingdom and France, under corporate law in Australia, and under securities legislation in the United States and Canada.[497]

496 Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEXAS LAW REVIEW 1385-1480 (2006), at page 1391.

497. For the U.K., see Company Directors Disqualification Act, 1986, c. 46, §§ 6-9 (mandating the disqualification of any individual who has served as a director for an insolvent company if a court determines that the individual's conduct makes that individual "unfit to be concerned in the management of a company"). For France, see C. Com. [Commercial Code], article 653-8 (Law 2005-845 of July 26, 2005 Journal Officiel de la Republique Francaise [J.O.] [Official Gazette of France], (July 27, 2005); Paul J. Omar, *French Insolvency Law and the 2005 Reforms*, 16 INTERNATIONAL COMPANY AND COMMERCIAL LAW REVIEW 490, 499 (2005). For Australia, *see* R.P. AUSTIN ET AL., COMPANY DIRECTORS: PRINCIPLES OF LAW AND CORPORATE GOVERNANCE 87-99 (2005) (discussing disqualification of directors under Corporations Act, 2001, No. 50, §§ 206B-206F). For Canada, *see* for example, Securities Act, R.S.O., ch.

This sanction, while it can have a financial impact, is principally reputational in nature. Thus, it may raise lesser concerns about the risk of government abuse of power than an administrative penalty. However, if the relevant statute of limitations permits, disqualification may be followed by a shareholder suit seeking damages based on the conduct that led to disqualification.

Under the current Russian Code of Administrative Procedure, administrative punishment, including disqualification, can be imposed only by a court. We do not recommend a change in this procedure. The court should make its own decision on whether the facts support a disqualification order and what period of disqualification is reasonable

Because the FSFM generally has regulatory power only over public companies, and because there is typically greater risk of harm to minority shareholders if an unfit person serves as a director or manager of a public company, we recommend that this power be limited to breach of duty by directors or managers of public companies, and that the sanction involve only disqualification from serving as a director or manager of a public company, not a private company.

Injunctions

Injunctions are not a customary part of the Russian legal system. Injunctions to enforce the provisions of company law also tend to be uncommon in the comparison countries with civil law legal systems. We do not recommend that the FSFM have the power to seek an injunction against a future violation of fiduciary duty under company law.

S-5, § 127(1) (1990) (authorizing the Ontario Securities Commission to issue orders requiring a director to resign and orders prohibiting individuals from "becoming or acting" as directors). For the U.S., the statutory standard for an order barring an individual from serving as a director is that "the person's conduct demonstrates unfitness to serve as an officer or director of [a public company]." Until 2002, a court order was required for such an order to be imposed. *See* Securities Act of 1933 § 20(e), 15 U.S.C. § 77t(e) (2006); Securities Exchange Act of 1934 § 21(d)(2), 15 U.S.C. § 78u(d)(2) (2006). The Sarbanes-Oxley Act of 2002 authorized the SEC to impose this sanction in an administrative cease and desist proceeding, subject to appeal to a court. *See* Securities Act of 1933 § 8A(f), 15 U.S.C. § 77h-1(f) (2006); Securities Exchange Act of 1934 § 21C(f), 15 U.S.C. § 78u-3(f) (2006) (added by Sarbanes-Oxley Act § 1105). The judicial review provisions are in Securities Act of 1933 § 9(a), 15 U.S.C. § 77i(a) (2006), and Securities Exchange Act of 1934 § 25(a), 15 U.S.C. § 78y(a) (2006).

Chapter 13. Criminal liability of members of company management organs

Subchapter 13.1 Criminal offenses of members of company management organs

Issue: Should legislation establish criminal liability of members of a company's management organs (managers and directors) for breach of duty to the company, established by company law? If yes, what is the description of these offenses? That is, what breaches of duty should give rise to criminal offences? This includes the following more specific questions:

- *Should there be criminal liability for breach of fiduciary duty involving a conflict of interest?*
- *Should there be criminal liability for breach of fiduciary duty not involving a conflict of interest?*
- *Should there be criminal liability for breach of fiduciary duty involving a failure of disclosure?*
- *Should there be other circumstances in which members of management organs face criminal liability for breaches of duty under company law?*

Russian context

Criminal liability of members of a company's management organs can arise under a number of provisions of the Criminal Code. These are general provisions of the Criminal Code that apply to members of management organs and other persons. There are no specific provisions establishing criminal liability for members of company management organs. In particular, a breach of the provisions of the JSC Law, including JSC Law art. 71, is a breach of a civil duty only, and does not give to criminal liability.

Under Russian criminal legislation, only a physical person can be held criminally liable. However, a physical person can be criminally liable for carrying out illegal decisions of a company's management organs. Often, a member of a company's management organs cannot technically commit criminal actions directly -- instead the company commits the actions. His role in the criminal act will consist of joint participation with other persons in causing the company to act illegally. Such a person can, for example, be liable:

- for *conspiracy* in the misappropriation of a legal entity's property (Criminal Code art. 160);
- for *joint participation as part of an organized group* in such criminal acts as the laundering of property (Criminal Code arts. 174, 174.1) or abuse in the issuance of securities (Criminal Code art. 185);or
- as a *sole perpetrator*, for illegal dissemination or use of information classified as a commercial secret (Criminal Code art. 183) or abuse of authority (Criminal Code art. 201).

The Criminal Code also provides for liability of an organization's manager for the following criminal acts. The persons who can be liable generally include the manager of the organization, deputies of this person, and other people who are managing the organization.

Offense	**Constituent elements**	**Penalty** (depends on severity)
abuse of authority (art. 201)	*Abuse of authority* is the use of authority by a person discharging managerial functions in an organization in defiance of the organization's lawful interests for the purpose of (1) deriving benefits and advantages for himself or for other persons or (2) inflicting harm on other persons, if this deed caused substantial damage to the rights and lawful interests of individuals or organizations	fine of up to 500,000 rubles or the salary of the convicted person for up to 3 years, community service for 180-240 hours, corrective labor for 1-2 years; arrest for 3-6 months, imprisonment for up to 5 years
commercial bribery (art. 204)	*Commercial bribery* is (1) the illegal transfer of money, securities, or any other assets to a person who discharges the managerial functions in an organization, and likewise the unlawful rendering of property-related services to him for the commission of actions (inaction) in the interests of the giver, in connection with the official position held by this person; or (2) the illegal receipt of money, securities, or any other assets by a person who discharges the managerial functions in an organization, or the illegal use of property-related services for the commission of actions (inaction) in the interests of the giver, in connection with this person's official position	fine of 100,000-500,000 rubles or the salary of the convicted person for up to 3 years, disqualification to hold specified offices or to engage in specified activities for up to 5 years, imprisonment for up to 5 years
illegal receipt of credit (art. 176)	*Illegal receipt of credit* is the receipt by an individual businessman or an organization manager of credit or favorable credit terms by knowingly submitting to a bank or another creditor false information about the economic position or financial condition of the individual businessman or organization, if this act has caused substantial damage	fine of up to 200,000 rubles or the salary of the convicted person for up to 18 months, arrest for 4-6 months, imprisonment for up to 5 years
deliberately evading repayment of debt (art.	*Deliberate evasion* of the repayment of substantial debts or of the payment for securities, after entry of an appropriate	fine of up to 200,000 rubles or the salary of the convicted person for up to 18 months,

Offense	Constituent elements	Penalty (depends on severity)
177)	court judgment	community service for 180-240 hours arrest for 4-6 months; imprisonment for up to 2 years
intentional bankruptcy (art. 196)	*Intentional bankruptcy* is the commission of actions (inaction) knowingly leading to the inability of a legal entity or individual businessman to fully pay its creditors or to make other paying obligatory payments, if these actions (inaction) have caused substantial damage	fine of 200,000-500,000 rubles or the salary of the convicted person for 1-3 years, imprisonment for up to 6 years plus a fine of up to 200,000 rubles
unlawful actions in the case of bankruptcy (art. 195)	*Unlawful actions in the case of bankruptcy*, if these actions (inaction) caused substantial damage. See Chapter 12.1 for the types of actions which are considered unlawful in the case of a bankruptcy.	restraint of liberty for up to 3 years, arrest for 2-4 months, imprisonment for up to 1 year with a fine of up to 80,000 rubles
abuse when issuing securities (art. 185)	*Abuse when issuing securities* is the deliberate entry of unreliable information in a prospectus for a securities issue, approval of a prospectus or a report on the results of a securities issue containing deliberately unreliable information, or the issuance of securities without state registration, if such actions have inflicted substantial damage to citizens, organizations, or the State	fine of 100,00-300,000 rubles or the salary or other income of the convicted person for 1-2 years, community service for 180-240 hours, corrective labor for 1-2 years.
deliberate refusal to provide information required under securities law (art. 185.1)	*Deliberate refusal to provide information* containing details of an issuer, the issuer's financial and economic activities and securities, transactions in securities, or the provision of deliberately incomplete or false information, if these actions have inflicted substantial damage to citizens, organizations, or the State	fine of up to 300,00 rubles or the salary or other income of the convicted person for 1-2 years, community service for 180-240 hours, corrective labor for 1-2 years

Some crimes also apply to individual proprietors. Several of these crimes require the relevant amount or harm to be "substantial." A comment to Criminal Code art. 196 indicates that this term generally refers to amounts exceeding 250,000 rubles, though a larger amount of 1 million rubles is specified for Criminal Code arts. 185, 185.1. A single action can result in commission of a crime under more than one provision of the Criminal Code.

One sometimes hears the opinion that an organization's manager who carries out a jointly-made decision is not subject to criminal liability. This opinion is incorrect. Under Criminal Code art. 42(2), (1) a person who committed an intentional criminal act in execution of an order or of an instruction known to be illegal shall be liable under usual terms, and (2) failure to execute an order or instruction known to be illegal shall preclude criminal liability. Moreover, if the manager of an organization, whose actions (inaction) caused damage, was not informed about the illegal nature of the decision which he carried out, he is not liable because he lacked criminal intent (Criminal Code art. 33(2). However, under Criminal Code art. 33(2), the members of the management organ who made the illegal decision bear criminal liability as the performers of the criminal act. If the manager of an organization knows of the illegality of a decision and refuses to carry it out, then, under Criminal Code art. 34(5), the members of the management organ who made the decision are liable for preparation for a criminal act[498]

In sum, the Criminal Code already includes a rather broad list of crimes in the sphere of company management and the securities market. One peculiarity is that members of a company's management organs can often bear liability as co-participants in a criminal act carried out by the manager of the organization.

Canada

Under the CBCA, directors' duties to the company under company law carry only civil liability, not criminal liability. CBCA § 251 states that every person who contravenes a provision of the CBCA for which no remedy is provided in the CBCA is guilty of an offence punishable on summary conviction. Since breaches of duty by directors can be remedied through a suit by the corporation, including the possibility for a derivative suit by shareholders in the name of the company, and through the oppression remedy, § 251 does not apply to breaches of duty by directors.

Under the OBCA, there is theoretically some scope for a criminal prosecution for misconduct amounting to a breach of duty by directors. OBCA § 258 provides that every person who, without reasonable cause, commits an act contrary to or fails to comply with any provision in the Act commits an offence. This means that a breach of the statutory provisions specifying directors' duties (primarily OBCA § 134) is technically punishable by prosecution. In practice, such proceedings are never brought.

498 Under Criminal Code article 34(5), a person who has not managed to act together with other persons in committing a crime due to circumstances beyond his control bears criminal responsibility for preparations for the crime.

France

With respect to criminal liability, there are specific provisions in the Code de Commerce arts. L. 242-1 to 242-30) with respect to company law. There is also criminal liability for violations of securities law, in the Code monétaire et financier arts. L. 461-1 to 466-1. Criminal sanctions for breach of directors' duties used to play a very important role in France. The recent reforms have, however, reduced the role of criminal sanctions in favour of private enforcement. Still, in comparison to the law of other Western European countries, the offences relating to management and administration are relatively extensive. In this respect, Code de Commerce art. L. 242-6 mentions four cases:

> (1) distribution of sham dividends;
>
> (2) false annual accounts;
>
> (3) the use (of) the company's property or credit, in bad faith, in a way which they know is contrary to the interests of the company, for personal purposes or to encourage another company or undertaking in which they are directly or indirectly involved; and
>
> (4) the use (of) the powers which they possess or the votes which they have in this capacity, in bad faith, in a way which they know is contrary to the interests of the company, for personal purposes or to encourage another company or undertaking in which they are directly or indirectly involved.

The third case (*abus de biens sociaux* = abuse of corporate assets) plays a very important role in practice. For instance, it has been held that any personal purpose is sufficient to create a violation. This purpose need not to be a financial interest.[499]

With regard to who can be liable, Code de Commerce art. L. 242-6 mentions directors and the CEO, but not the assistant general managers. Article L. 245-16 extends liability to anyone who, directly or through an intermediary, has run, administered or managed these companies under the guise or in place of their legal agents. Article L. 247-9 states that if the company has a two-tier board, members of both the supervisory board and the management board can be liable. However, a valid delegation may relieve a particular director or officer from criminal liability.[500]

For failure to disclosure, Code de Commerce art. L. 242-8 makes directors, the CEO and assistant general managers liable if they do not prepare an inventory, annual accounts and an annual report for each financial year.

Germany

There are some criminal provisions in the Aktiengesetz itself (§§ 399-404). However, these do not concern simple breaches of directors' duties, but concern only infringements of disclosure provisions, for instance, failure to inform about the company's insolvency (AktG § 401) or a breach of secrecy (AktG § 404).

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499 Cass. crim. 19 juin 1978, Bull. crim. no. 202; 20 mars 1997, RJDA 10/97 no 1207.

500 PAUL LE CANNU, DROITS DES SOCIETES § 278 (2nd edition, 2003).

There can, however, be criminal sanctions for breach of securities law (e.g., insider dealing, securities fraud), based on the German Securities Trading Act (WpHG) § 38.[501]

Third, the general criminal law (StGB) can occasionally have a significant impact. A recent example is the prosecution against two supervisory board members of the former Mannesmann AG (including the chairman, who is also the CEO of Deutsche Bank, Josef Ackermann). The board members were accused of "breach of trust" (*Untreue*) under StGB § 266(1)[502] because they approved large payments ("appreciation awards") to Mannesmann executives when they ended their resistance against a takeover bid made by Vodafone. The district court acquitted the board members, but the German Supreme Court ordered a retrial.[503] The government and the defendants were then able to settle the matter. The defendants paid a large fine ($4.2 million for Mr. Ackermann), but did not admit guilt.

Still, on the whole, criminal prosecutions for breach of company law are quite rare, as are prosecutions of company managers for breach of securities and other laws.[504]

Japan

Japanese Criminal Code art. 247 contains provisions which are generally comparable to Korean Criminal Code art. 3456, which establishes the crime of *Bae-Im*. This crime is discussed below. However, Japanese law requires intent to defraud the company, while Korean law does not.

Korea

Criminal liability may be attached to directors for breaches of their duties under the Korean Criminal Code. The base for the liability is especially disconcerting to directors in Korea because the courts quite often sanction the sale of shares in private companies at a price that does not reflect fair value. This is a serious matter given that there is no widely accepted and court-approved appraisal method for stocks of private companies.

In Korea, an officer or a director of a company may also be criminally prosecuted for failure in business judgment with respect to the investments and the operation of the company. This involves the crime of *Bae-Im* (Korean Criminal Code art. 356). According to the law, the elements of the offense are that the wrongdoer (1) owes a

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501 An English translation of this law can be found on the BaFIN home page at http://www.bafin.de/gesetze/wphg_en.htm.

502 This provision states: "Whoever abuses the power accorded him by statute, by commission of a public authority or legal transaction to dispose of assets of another or to obligate another, or violates the duty to safeguard the property interests of another incumbent upon him by reason of statute, commission of a public authority, legal transaction or fiduciary relationship, and thereby causes detriment to the person, whose property interests he was responsible for, shall be punished with imprisonment for not more than five years or a fine."

503 Federal Supreme Court (BGH) 21.12.2005 - Az: 3 StR 470/04, NJW 2006, 522.

504 Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries,* 84 TEXAS LAW REVIEW. 1385-1480 (2006), at 1472.

fiduciary duty to an entity, (2) breaches that fiduciary duty with intent, (3) obtains pecuniary gain or causes a third person to obtain it, and (4) cause financial harm to the entity. Courts have interpreted the “intent” requirement to mean “reckless disregard” for the probability of one’s action causing financial harm to the company.

The crime of *Bae-Im* can occur without intent to defraud the company. It can occur without the defendant having taken or converted another’s money or property for his own use. Because of this, Korean courts are able to impose criminal liability on directors and officers of companies who have managed their business organizations poorly. The courts have been criticized by legal scholars for applying the crime of *Bae-Im* too widely.

The crime of *Bae-Im*, has important practical implications for corporate governance in Korea. Although the risk of a shareholder derivative suit and/or a hostile takeover attempt has been lower than in some other countries, especially the United States, the crime of *Bae-Im* has been utilized to challenge corporate managers and/or officers’ business actions.

The KCC also contains the crime of *Bae-Im*, although the relevant provision, KCC art. 622, is often preempted by Korean Criminal Code art. 356:

> ***Article 622*** (Crimes of Special *Bae-Im* by Promoters, Directors, and Other Officers, etc.) of the KCC.
>
> (1) If a promoter, managing member, director, member of audit committee, auditor or acting director under Articles 386 (2), 407 (1), 415 or 567, manager or other employee commissioned to undertake a certain class of matters or specified matters related to the business affairs of the company has obtained, or made a third party obtain, any pecuniary benefit by acting in breach of his duty and has thereby inflicted loss on the company, he shall be punished by an imprisonment not exceeding ten years or to a fine not exceeding thirty million won.
>
> (2) The same shall apply where a liquidator, acting liquidator under Article 542 (2) and incorporator under Article 175 have committed an act mentioned in paragraph (1).

Korean directors and managers can potentially be found criminally liable under statutes in other areas of law as well. The principal relevant areas are:

- **Securities law.** A representative director or director of a public company may be found criminally liable if implicated in providing any false or misleading statements or practices concerning the affairs of the company. A fine will be imposed on such company in addition to the punishment of the offending director.
- **Health and safety and environment**. In Korea, a representative director or director of a company may be held criminally liable for breaches of health and safety regulations and of environmental legislation where it is shown that the director contributed to the breach through consent, connivance or neglect.
- **Antitrust**. A representative director or director of a company may be found criminally liable if implicated in specified violations of antitrust law.

United Kingdom

Breaches of duty owed by directors to their company give rise only to civil liability. They are not punishable, as such, by criminal sanctions. However, various specific provisions of the companies legislation that impose obligations on directors prescribe criminal sanctions for breach.

Companies Act 1985 Schedule 24 lists the provisions which give rise to criminal liability. The principal provisions that concern circumstances which could also involve a breach of directors' duties, are:

- Companies Act 1985, § 314 (failure by a director to disclose compensation payable on a takeover) (the replacement provisions in Companies Act 2006, §§ 215-222 do not include criminal sanctions);
- Companies Act 1985, § 317 (failure by a director to disclose an interest in a contract with his company) (modified and replaced by Companies Act 2006, § 183);
- Companies Act 1985, § 322B (failure to record in writing a contract between a director and a private company of which he is the sole shareholder) (replaced by Companies Act 2006, § 231);
- Companies Act 1985, § 342 (offences in connection with loans by a company to its director(s)) (the replacement provisions in Companies Act 2006, §§ 215-222 do not include criminal sanctions); and
- Companies Act 1985, § 343 (failure by a banking company or credit institution to record certain loan and similar transactions between a director and the company which are not disclosed in the company's accounts because the company has lawfully taken advantage of a rule which allows such nondisclosure) (the replacement provisions in Companies Act 2006, §§ 215-222 do not include criminal sanctions).

The Companies Act 2006 reduces the extent to which violations of the companies law are punishable by criminal sanctions. Of the five provisions listed above, only two are included in the new law.

The rationale for imposing criminal sanctions was thoroughly explored by the Company Law Review Steering Group, the body vested with primary responsibility for recommending changes to company law as part of a government effort to reform company law extending back to the late 1990s. The Steering Group supported continued use of criminal sanctions in company law, saying such penalties exert a chilling effect on potentially wayward directors and thereby help to reduce the adverse effects of directors' conflicts of interest.[505] The Steering Group said this occurred principally through two channels. First, the threat of criminal sanctions influences directors' behaviour directly.

505 See COMPANY LAW REVIEW, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: COMPLETING THE STRUCTURE (Department of Trade and Industry, 2000); COMPANY LAW REVIEW, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY – FINAL REPORT chapter 15 (Department of Trade and Industry, 2002).

Second, provisions supported by criminal sanctions give a lever to professional advisors who seek to ensure that directors do not fall into conflicts of interest. For example, a lawyer can point out the criminal sanctions attaching to certain conduct, tell the client to comply with the law, and refuse to be party to any illegal conduct. In practice, however, criminal offences under these provisions of the Companies Act are rarely prosecuted.[506] Consequently, it cannot be taken for granted that directors are themselves aware of and thus are deterred by the prospect of criminal penalties. We are unaware of any study that offers direct evidence about directors' knowledge of their potential criminal liability.

As for criminal sanctions providing legal advisers with leverage to discourage directors from infringing statutory measures, one U.K. study addresses professional advisors' reactions to criminal penalties for undisclosed, conflicted action by directors.[507] Based on "background interviews with legal practitioners," the study suggests that "the possibility of criminal sanctions can concentrate the minds of directors," because "[a]dvisers feel that without the threat of such sanctions, it would be more difficult for them to persuade certain directors to avoid certain transactions of dubious legality." Consequently, the study concludes, "We do not have any direct evidence of this use of the law, but frequent references by practitioners suggest that the threat of criminal liability may, through the medium of legal advice, have a significant influence on behavior in practice."

Since these reports were published, a new dimension has been added to criminal sanctions which may prove to be important and render them very effective – perhaps too effective. This is the Proceeds of Crime Act 2002. Since the relevant portions of the Act (Parts 5 and 7) only came into force in 2002 and 2003, thus far there has not been serious academic analysis of the Act's impact on the efficacy of criminal sanctions in corporate law. Nevertheless, there is reason to believe the changes to the law might do much to induce professional advisers to press for compliance of corporate law provisions supported by criminal sanctions.

The core purpose of the Proceeds of Crime Act 2002 is to provide for the recovery of benefits made through criminal activity. The law can also implicate professional advisors. Under § 329 of the Act, a person who acquires, uses or has possession of "criminal property" commits an offence, subject to applicable defenses. For these purposes, property is "criminal property" if it constitutes a person's "benefit" from criminal conduct and the alleged offender knows or suspects that it constitutes or represents such a benefit. Section 329 could potentially catch fees earned by professionals who give advice in connection with a transaction that involves a criminal offence, given the broad relevant definitions in the Act (see § 340). In addition, under §

506 See LAW COMMISSION, COMPANY DIRECTORS: REGULATING CONFLICTS OF INTERESTS AND FORMULATING A STATEMENT OF DUTIES § 10.2 (1998). See also Department of Trade and Industry, Companies in 2004-2005, Table D3 (2006), at http://www.dti.gov.uk/files/file13424.pdf.

507 See SIMON DEAKIN & ALAN HUGHES, DIRECTORS' DUTIES: EMPIRICAL FINDINGS – REPORT TO THE LAW COMMISSIONS (1999), *at* http://www.lawcom.gov.uk/docs/study.pdf (position paper prepared by the ESRC Centre for Business Research at the University of Cambridge for the English and Scottish Law Commissions). See also SIMON DEAKIN, ECONOMIC EFFECTS OF CRIMINAL AND CIVIL SANCTIONS IN THE CONTEXT OF COMPANY LAW, RESEARCH NOTE FOR THE DTI COMPANY LAW REVIEW (2000), *at* http://dti2info1.dti.gov.uk/cld/deakin_z.pdf.

328 of the 2002 Act, a person commits an offence, again, subject to relevant defenses, if he enters into, or becomes concerned in, an arrangement which he knows or suspects facilitates the acquisition, retention, use or control of "criminal property" by or on behalf of another person. This too could catch professionals advising on corporate transactions that involve misconduct punishable by criminal sanctions.

The 2002 Act does offer a defense to professional advisers who otherwise would breach §§ 328 and 329, but have made an "authorized disclosure" of the facts to government authorities (see § 338). Cautious professional advisers, to avoid committing a crime themselves, may opt to make such disclosures if they suspect a transaction is punishable by criminal sanctions. They may also, where possible, avoid providing advice on transactions which potentially might breach statutory measures punishable by fines or imprisonment. In sum, though it is still too early to say yet, the Proceeds of Crime Act 2002 may ensure criminal sanctions have real teeth in the context of corporate law.

United States

A breach of duty under corporate law is a civil violation only, and does not give rise to criminal liability. However, some breaches of the duty of loyalty can potentially be prosecuted under other statutes, which govern theft and fraud. For example, two executives of Tyco have been convicted for taking compensation from the company without proper approval by the board of directors. And an outside director of Tyco settled a criminal prosecution, by paying a fine, where the basis for the prosecution was that he had received compensation in connection with a merger which was approved by Tyco's CEO, but was not disclosed to the board of directors.

There is also criminal liability for most violations of federal securities law, including some of the provisions of the Sarbanes-Oxley Act. For public companies, securities law requires extensive disclosure of self-dealing transactions. If this disclosure is not made, criminal liability can result.

Summary and recommendations

The comparison countries are mixed with regard to whether a breach of fiduciary duty can be a criminal offense, and indeed with regard to whether any violation of company law can be a criminal offense. We summarize the criminal sanctions available in each country for breach of duty under company law, in table form, in subchapter 12.1 above. There are three main approaches:

- There is no specific criminal liability for breach of duty to the company under company law (United Kingdom, United States, Canada under the CBCA). However, in all countries, serious misconduct can often be prosecuted under other laws or other criminal provisions, for example when the misconduct involves theft, embezzlement, commercial bribery, or fraud.
- There is a general provision in the criminal law under which company officials can be prosecuted for misuse of their positions (France, Germany).

- There is some additional criminal liability for particular violations of the company law, including violations involving breach of duty by company officials (France, Japan, Korea, Canada under the OBCA).

Russian law is perhaps most similar to German law. Misuse of official position can be prosecuted under Russian Criminal Code art. 201. This provision is similar in concept to a breach of trust under German law.

With the exception of France and perhaps Korea, criminal prosecutions under provisions that apply specifically to breach of duty under company law are rare. Moreover, when criminal prosecutions take place for conduct that does not involve personal advantage, commentators often criticize the prosecution for bringing inappropriate cases. Such criticisms are present in France, Germany (for the *Mannesmann* case, which is the only known case in which the crime of breach of trust has been invoked), and in Korea. Legislative reforms in France have responded to these criticisms by reducing the range of actions by company directors and managers which can result in criminal liability.

For Russia, we do not recommend expansion of the current bases for criminal liability. One reason for this view is concern about whether this strong power, if granted, will be properly used. Russian experience provides reason for caution in this regard. Moreover, in some instances, when prosecutors have brought criminal proceedings against company directors and managers, they have not been content to bring the proceedings against the directors and managers, but have also in some cases brought actions against legal counsel. Lawyers in Moscow, who specialize in advising companies have expressed strong concerns to us, based on their experience, about whether the prosecutor can be relied on for impartial enforcement of the law. Even if these lawyers' concerns are sometimes not well-grounded, they suggest that investor confidence may not increase if criminal sanctions are increased.

Experience in other countries also provides reason for caution. When there is a high-profile corporate transaction or scandal, the prosecutors may find political advantage in bringing charges, even when there is not a strong basis for these charges.

In Germany, for the *Mannesmann* prosecution, it is not apparent to an outside observer that there was a breach of fiduciary duty *at all* in the decision by the Mannesmann board to award a bonus to the Mannesmann CEO (with the prior approval of Mannesmann's controlling shareholder), let alone a breach of sufficient gravity to justify criminal proceedings. In the United States, there have been instances in which prosecutors have sought to stretch general criminal provisions to reach conduct by corporate actors, only to have convictions reversed on appeal because the appellate court found that the action was not criminal.

Moreover, for the more egregious examples of self-dealing, there may be criminal liability under existing law, governing fraud and theft. Thus, in the United States, there is no criminal liability for breach of fiduciary duty under corporate law, but there are frequently prosecutions for fraud, both securities fraud and general fraud. In Russia, too, criminal sanctions are already available for conduct by company directors and managers that amounts to theft or to abuse of one's position for personal gain. Thus, the question is not whether there should be any criminal liability of directors and managers, but instead whether that liability should extend to breaches of duty that are not already captured by general provisions of the criminal law.

On the whole, then, the potential for criminal liability in Russia exceeds that in several of the comparison countries, and is similar to the situation in Germany. In the two countries which have both a greater degree of criminal liability for breach of duty to the company and a significant number of prosecutions (France and Korea), the prosecutors have been criticized for misuse of their powers. Thus, we do not recommend expansion of the current provisions of Russian law on criminal liability.

Subchapter 13.2 Procedural aspects of criminal liability of members of company management organs

Issue: What should be the methods and procedures through which criminal liability is established? This includes the following more specific questions:

- *Can the regulator of financial markets seek criminal sanctions, or can only the prosecutor do so?*
- *Can the courts assess criminal penalties for breach of duty under company law? If so, in what amounts?*
- *Can the courts impose jail terms for breach of duty under company law? If so, within what limits?*
- *Can the courts enjoin future violations of the law? If so, what are the consequences if the injunction is not obeyed?*

Russian context

The Criminal Procedure Code regulates the procedural aspects of assigning criminal liability to members of a company's management organs. Thus, for example, the Criminal Procedure Code provides that, if an act specified in Criminal Code chapter 23 (in particular, Criminal Code art. 201 on Abuse of Authority and art. 204 on Commercial Bribery), caused damage to the interests of a commercial or other organization that is not a state or municipal enterprise and did not harm the interests of other organizations, other persons, the company, or the State, a criminal case can be filed only through the petition of the manager of the organization or with his consent.

There are also some discrepancies between the Criminal Code and the Criminal Procedure Code that are relevant for this special procedure. In particular, under Criminal Code art. 201, a petition or consent is required from the organization, while Criminal Procedure code chapter 23 stipulates that consent should come from the manager of the organization. The latter rule makes it unclear what should happen if the manager is himself suspected of committing a criminal act, since he would then be unlikely to provide consent.

The Federal Service on the Financial Market does not have the authority to initiate or participate in investigating a criminal case with respect to the member of a company's management organs. If an officer of the FSFM has information which can serve as the basis for initiating such a criminal case, such information can be communicated to the prosecutor under general norms of criminal-procedure (Criminal Procedure Code art. 140).

Canada

Only the prosecutor can bring a criminal case. The financial markets regulator and the companies regulator cannot do so. It can, of course, refer cases to the prosecutor's office, but the prosecutor has discretion in deciding which cases to pursue.

Under the CBCA, breaches of duty by directors are not punishable by criminal sanctions, so this question is moot.

For the OBCA, criminal violations are generally punishable by a fine of up to $2000 and a year's imprisonment. Prosecutions under the OBCA can only be brought with the consent of the Minister of Consumer and Business Services (OBCA § 257). The OBCA does not provide courts with explicit authority to enjoin future violations of the law, but it is possible that they may have this authority under general provisions of law.

France

If there is criminal liability the ordinary laws on criminal procedure apply. The powers of the regulators of financial markets (BaFIN and AMF) do not include seeking criminal penalties. They must instead inform the public prosecutor. For instance, Article L. 621-20-1 of the Code monétaire et financier states:

> If, within the scope of its remit, the AMF has knowledge of a crime or an offence, it is required to inform the Public Prosecutor thereof without delay and to send him all the relevant information, statements of offence and other documents.[508]

In some cases, courts or the prosecution may request, or sometimes may be required to request an opinion from the AMF.[509]

With regard to penalties, a breach of the extensive Article L. 242-6 of the Code de Commerce (discussed in the previous subchapter) can be punished by a prison sentence of up to five years and/or a fine of up to €375,000. A breach of the duty to prepare accounts is punished by a fine of up to €9,000 (Code de Commerce, art. L. 242-8).

With respect to the calculation of the penalty, the general rules of the French Criminal Code (Code penale)[510] are applicable. For instance, its Article 132-24 states:

> Within the limits fixed by Statute, the court imposes penalties and determines their regime according to the circumstances and the personality of the offender. When the court imposes a fine, it determines its size taking into account the income and expenses of the perpetrator of the offence.

Criminal law is concerned with punishing past violations, and is not concerned with possible future violations of the law (although offenders may be released on parole, in which case a violation of the conditions of the parole may lead to imprisonment). Thus,

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508 A similar provision is found in the French Code of Criminal Procedure (Code de Procedure Penale), article 40(2).

509 See Code de Commerce, article L. 247-2(5) (concerning criminal liability arising from the failure to disclose major shareholder ownership, where for a company which has issued securities to the public, proceedings are initiated after the advice of the AMF has been sought); Code monetaire et financiere, arts. L. 465-1, 466-1(¶ 2) (in cases of insider trading the criminal courts must request the opinion of the AMF). In other cases the courts *can* request the opinion of the AMF and *may* call upon its chairman or his representative to make submissions). *See* Code monetaire et financiere, arts. L. 466-1(¶ 1), 621-20.

510 An English translation is available at http://195.83.177.9/upl/pdf/code_33.pdf.

an injunction against future violation of the law is not one of the available criminal remedies.

Germany

If there is criminal liability, the ordinary laws on criminal procedure apply.

Violations of the criminal provisions of the German Law on Joint Stock Companies (AktG) are punished with imprisonment for not more than three years (up to five years if the crime was committed with intent) or a fine. "Breach of trust" under the German Criminal Code (StGB) § 266(1) is punished by imprisonment for up to five years or a fine.

The calculation of the fine follows StGB § 40:[511]

> (1) A fine shall be imposed in daily rates. It shall amount to at least five and, if the law does not provide otherwise, at most three hundred and sixty full daily rates. (2) The court determines the amount of the daily rate, taking into consideration the personal and financial circumstances of the perpetrator. In doing so, it takes as a rule the average net income which the perpetrator has, or could have, in one day as its starting point. A daily rate shall be fixed at a minimum of two and a maximum of ten thousand German marks. (3) In determining the daily rate the income of the perpetrator, his assets and other bases may be estimated. (4) The number and amount of the daily rates shall be indicated in the decision.

Korea

The regulator of financial markets cannot seek criminal sanctions on its own.

Anyone, including the financial regulator, can file a charge (a request that the prosecutor initiate criminal proceedings) with the Public Prosecutor's Office. The procedures for bringing charges against corporate directors are not different from those in other types of criminal cases.

United Kingdom

As regards standing to enforce criminal sanctions in company law, in general anyone may bring a prosecution, unless either (a) legislation provides to the contrary (Companies Act 1985 § 732, replaced by Companies Act 2006, § 1126, so provides, but only for offences which are not relevant for present purposes), or (b) the Attorney-General, the public official with primary responsibility for bringing prosecutions under U.K. legislation, or another authorised state official halts a prosecution by a *nolle prosequi* motion. In principle, the Financial Services Authority could enforce a criminal sanction, subject to these two limits. In practice, the FSA does not do so, nor do private persons bring prosecutions for offences under company law.

511 An English translation is available at http://www.iuscomp.org/gla/statutes/StGB.htm (but not the most recent version).

The punishments that can be imposed on directors for breaches of companies legislation, these can include fines and/or imprisonment, with the severity varying based on the specific statutory provision. The maximum penalty on conviction for each offence under the Companies Act 1985 is set out in Schedule 24 to that Act (there is no similar table in the Companies Act 2006).

In England, under the common law, the Attorney-General can obtain an injunction from the courts prohibiting criminal activity. Case law authority suggests the Attorney-General can obtain such an order where the criminal activity by the defendant is so frequent that his/her conduct shows that otherwise available criminal penalties are inadequate to deter his/her disregard for the law.[512] Such applications are, in practice, never made in relation to corporate law.

United States

As discussed above, breaches of duty by company managers and directors give rise to civil liability and not criminal liability. Thus, the issues of the power of the financial regulator and the amount of any sanctions do not apply.

With respect to violations of securities law, the SEC cannot bring criminal charges itself. It can refer cases to the prosecutor. The procedures are the same as for other criminal cases.

The Securities and Exchange Commission can bring a petition for an injunction against future violations, as a civil matter. A violation of such an injunction could give rise to criminal penalties.

Summary and recommendations

In all of the comparison countries, to the extent that criminal liability exists for breach of duty under company law, or for offenses under securities law, an action can be brought only by the prosecutor, not by a regulator. See the summary table provided in subchapter 12.1. In all comparison countries, the usual rules of criminal procedure apply to any such proceeding, brought by the prosecutor.

Thus, whatever the scope of criminal liability for breach of duty under company law may be, we do not recommend that the FSFM have the power to bring such an action. We also see no need for there to be special procedures to govern an action brought by the prosecutor. We therefore recommend no changes in current law or practice.

The FSFM will have, of course, the power to inform the prosecutor of evidence of criminal activity. The investigative powers of the FSFM will assist in developing evidence of this activity. The FSFM will also have the ability to assist the prosecutor in bring such a case. This assistance is common, for example, in the United States under securities law. In many cases, the local prosecutor's office does not have skill or experience in bring complex securities cases. The prosecutor therefore relies heavily on

512 *Gouriet* v. *Union of Post Office Workers* [1978] A.C. 435 at p. 481 (Lord Wilberforce).

support from the SEC. Sometimes, the SEC provides personnel to the prosecutor's office, who work on the criminal case under the general authority of the prosecutor. A similar approach could be appropriate in Russia.

Conclusion

A decade of experience with the Russian Law on Joint Stock Companies has, predictably, revealed areas of both strength and weakness. One area of weakness involves the liability of members of a company's management organs for breach of duties owed to the company. In practice, it is rare for members of management organs to be found liable. This Report contains our recommendations in a number of areas, addressed to the overall issue of when a company's directors, managers, and controlling shareholders should have duties to the company, what those duties should be, and the procedures through which liability can be established.

Practical Difficulties in Establishing Liability, and Partial Solutions

The practical difficulties with establishing liability arise in a number of areas. First, the duties owed to the company are sometimes unclear. The scope of these duties should be clarified and, in some respects, expanded. The requirement of good faith should be defined, by reference to a concept of a conflict of interest, which itself should be defined, and defined broadly to include both direct and indirect interests. The duty to be reasonably informed should be made an explicit part of the duty of reasonableness. Duties of disclosure and of confidentiality should be explicitly stated.

Second, the scope of the persons who owe duties to the company should be widened. For transactions which involve a conflict of interest, controlling shareholders should owe a duty of good faith to the company.

Third, the question of presumptions and burden of proof should be addressed. We propose that for a transaction that does not involve a conflict of interest, a company's directors and managers should be required to obtain reasonable information as a basis for adopting a decision but that if they have done so, they should benefit from a presumption that they have acted reasonably. In contrast, if a director, manager, or controlling shareholder has a conflict of interest with regard to a transaction with a company or its subsidiary, once the plaintiff provides evidence that a conflict of interest may exist, the director, manager, or controlling shareholders should have the burden of showing either that no conflict of interest existed in fact, or else that this person has satisfied the duty of good faith despite the existence of a conflict of interest, by providing disclosure of the conflict and ensuring that the transaction is fair to the company and has been approved by non-interested decisionmakers.

Fourth, there are important procedural obstacles which make it difficult, in practice, for shareholders to bring a suit against a company's directors and officers. These procedural obstacles derive from the difficulty in bringing a collective action on behalf of a number of shareholders, from the nature of a derivative suit, in which recovery is paid to the company, and from rules of civil procedure, under which a shareholder-plaintiff will generally be responsible for his own legal expenses and some of the defendants' expenses, if a case is lost, yet will bear most of his own expenses even if the suit is successful. Under these circumstances, a shareholder plaintiff will suffer a direct out of pocket cost from bringing a derivative suit, no matter what the outcome. This outcome must be altered to make it financially reasonable for shareholders to bring derivative suits.

Limits on Liability Risk

While the current level of liability risk is low, and the reforms just discussed above will increase it, the degree of liability risk faced by directors and managers should not become too high. The risk of liability can make it difficult for companies to find qualified outside directors, and can cause these persons to be too cautious in embracing business risks, because the benefits from taking a risky decision which turns out to be successful will accrue to the company, but the potential cost if the decision turns out to be unsuccessful may be borne personally by the directors. As a result, we favor a number of steps to limit the risk faced by directors, especially outside directors.

First, as noted above, when directors act on an informed basis and without a conflict of interest, they should be protected by a presumption of reasonableness, sometimes known as a "business judgment rule."

Second, directors should be permitted to be indemnified by the company, and also protected by D&O insurance, against legal expenses arising out of their official duties, including advancement of legal expenses before the outcome of a case is known.

Third, with regard to damages, directors who act without a conflict of interest should be permitted to be indemnified for damages paid to third parties, and the company should also be permitted to purchase D&O insurance against liability either to the company or to third persons.

Fourth, we do not favor expansion of the scope of liability in a number of areas. We do not recommend additional liability when a company becomes insolvent. We also do not recommend providing for administrative or criminal penalties for breach of duty under the JSC Law. The principal source of liability should be civil suits by shareholders, not the fear of action by the government.

Overall Assessment

Russia benefits from a modern Civil Code and a modern JSC Law. Both, on the whole, provide reasonable regulation with regard to the liability of directors and managers. As a result, the recommendations in this Report, while important, are incremental in nature. The general structure of liability in Civil Code art. 53 and JSC Law art. 71 is sound. The most important reforms may well lie elsewhere, in the rules of civil procedure that discourage derivative suits, prevent class actions, and make claims of self-dealing difficult to prove; in the weakness of the Russian judiciary; in the lack of full disclosure of ownership, without which it is not feasible to regulate transactions in which a controlling shareholder has a conflict of interest; and in the weakness of Russia's accounting profession, which often permits transactions involving a conflict-of-interest to remain undisclosed.

Some of these problems are within the scope of this Report. Some are beyond its scope. All need attention. The recommendations in this Report can be a step toward appropriate regulation of directors, managers, and controlling shareholders of joint stock companies.

They are neither the first step, nor the last, but instead can represent an opportunity for progress along the road to developing world-class standards of corporate governance.

Glossary of Terms with Specialized Meanings

assistant general manager	French term, used to refer to a small number of senior managers who are subordinate to the general managers (CEO).
CEO	Chief Executive Officer (also known as the general manager or the general director)
controlling shareholder	Person who, together with his affiliated persons, directly or indirectly holds or controls the voting of 30% or more of the company's voting shares, so that this shareholder may, as a practical matter, be able to control the composition of the board of directors and the major decisions adopted by the company
corporate governance	An overall system for governing the management and control of a company, including its organizational structure, business policy principles, guidelines, and internal and external regulation and monitoring mechanisms.
derivative suit	a suit brought by a shareholder in the name of the company, including a suit against a member of the board of directors, a member of the company's executive organ, or a controlling shareholder for breach of duty to the company
executive director	A member of the board of directors who also holds a position as a manager of the company or an affiliated company.
executive organ	A company may have either an individual or a collegial executive organ.
independent director	A non-executive director who meets the standards for independence specified in the JSC Law.
inside director	same meaning as executive director
management board	Collegial executive organ of a joint-stock company
management organs	Board of directors and executive organ
manager	A senior executive of a company, including the members of the management board for a company with a management board.
non-executive director	A member of the board of directors who does not hold another position with the company or an affiliated company
non-public company	A company whose common shares are not publicly traded on the open market.
officer	This concept is used in common law countries to refer to the senior executives of a company. Officers have the same duties to the company as directors. The courts determine whether a person is an officer based on the person's activities, not the person's formal title or formal authority.
outside director	Same meaning as non-executive director.
public company	A company which has issued common shares to the public. Includes all companies whose shares are actively traded, including companies whose shares are not "listed" on a securities

	exchange.
supervisory board	In a two-tier board system, as in Germany, the upper board is called the supervisory board. A principal duty of the supervisory Board is to appoint the members of the management board.

List of Principal Laws and Abbreviations

Austria: Principal Laws	
Austrian Aktiengesetz (Austrian AktG)	Austrian Law on Joint Stock Companies
Austrian GmbH Gesetz (Austrian GmbHG)	Austrian Law on Limited Liability Companies
Austria: Abbreviations	
Austrian BGBl	Austrian Federal Law Gazette
OGH	Austrian Supreme Court
ÖIAG	Österreichische Industrieholding Aktiengesellschaft {Parent company for Austria's nationalized industries, now acts as a privatization agency)
Canada: Principal Laws	
CBCA	Canadian Business Corporation Act (available at http://www.canlii.org/ca/sta/c-44/)
OBCA	Ontario Business Corporations Act (available at http://www.canlii.org/on/laws/sta/b-16/20060718/whole.html)
Canada: Abbreviations	
S.C.R.	Supreme Court Reports
European Union: Principal Directives	
Recommendation 2005/162/EC	Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2005/l_052/l_05220050225en00510063.pdf
	Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company
Directive 2006/46/EC	Directive 2006/46/EC of 14 June 2006 on the annual accounts and consolidated accounts of companies (amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings)

EU: Abbreviations	
SE	European Company (*societas europaea*)
France: Principal Laws and Decrees	
Code de Commerce 2000	French Commercial Code, as amended (English translation available at http://195.83.177.9/code/liste.phtml?lang=uk&c=32 (but not the most recent version)
Code monétaire et financier	French Monetary and Financial Code (English translation available at http://195.83.177.9/code/liste.phtml?lang=uk&c=25)
Code penale	French Criminal Code (English translation available at http://195.83.177.9/upl/pdf/code_33.pdf)
Décret no 67-236 sur les sociétés commerciales (as amended)	Decree interpreting the provisions of the Code de Commerce concerning companies
	Décret no 93-1298 du 13 décembre 1993 instituant une action spécifique de l'Etat dans la Société nationale Elf-Aquitaine
	Loi no 83-675 du 26 juillet 1983 relative à la démocratisation du secteur public (as amended)
France: Abbreviations	
AMF (Autorité des Marchés Financiers)	French regulator of financial markets
BRDA	Bulletin Rapide du Droit des Affaires (journal)
CA Lyon	Cour d'Appel de Lyon
CA Paris	Cour d'Appel de Paris
Cass. com.	Cour de cassation (Chambre commerciale)
Cass. soc.	Cour de cassation (Chambre sociale)
PDG	Président Directeur General
Rev. soc.	Revue des sociétés (journal)
RJDA	Revue de Jurisprudence de Droit des Affaires (journal)
SARL	French Limited Liability Company
SAS	French Simplified Joint Stock Company
Germany: Principal Laws	
Aktiengesetz (AktG)	German law on joint-stock companies
BGB	German Civil Code
FinDAG (Finanzdienstleistungsauf-sichtsgesetz)	Act Establishing the German Federal Financial Supervisory Authority
GmbH Gesetz (GmbHG)	German Law on Limited Liability Companies
InsO	German Insolvency Law
KWG (Kreditwesengesetz)	German Banking Act
MitbestG	German Co-Determination Act, 1976
OWiG	German Regulatory Offences Act

StGB	German Criminal Code (English translation available at http://www.iuscomp.org/gla/statutes/StGB.htm) (not the most recent version)
StPO	German Code of Criminal Procedure
UMAG	Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (2005 amendments to the AktG)
VVG	German Law on Insurance Contracts
WpHG	German Act on Securities Trading (English translation available at http://www.bafin.de/gesetze/wphg_en.htm)
Germany: Abbreviations	
BaFIN	Bundesanstalt für Finanzdienstleistungsaufsicht - the regulator of financial markets in Germany
BGBl	German Federal Law Gazette
BGH	Bundesgerichtshof (German Federal Supreme Court)
BGH DStR	German Federal Supreme Court decisions, as reported in Deutsches Steuerrecht journal
BGH GmbHR	German Federal Supreme Court decisions, as reported in GmbH-Rundschau journal
BGH NJW	German Federal Supreme Court decisions, as reported in Neue Juristische Wochenschrift journal
BGH WM	German Federal Supreme Court decisions, as reported in Wertpapier-Mitteilungen journal
BGHZ	Entscheiungen des Bundesgerichtshofes in Zivilsachen (Official collection of German Federal Supreme Court decisions on issues of civil law)
GDV	German Insurance Association
GmbH	German limited liability company
NJW	Neue Juristische Wochenschrift (journal)
RGZ	Official collection of the (former) Supreme Imperial Court in issues of civil law
ZHR	Zeitschrift für das gesamte Handelsrecht
Italy: Principal Laws	
	Codice Civile (Italian Civil Code; includes company law)
Japan: Principal Laws	
JCC	Japanese Commercial Code
Korea: Principal Laws	
KCC	Korean Commercial Code (English translation of Companies portion of KCC available at www.moleg.go.kr/english; click on Economic Laws for list of laws; on page 5 of the list, click on law no. 14 , "Commercial Act")

KSEA	Korean Securities and Exchange Act
Korea: Abbreviations	
KDIC	Korea Deposit Insurance Corporation
Latvia: Principal Laws	
Latvian Commercial Code	(English translation available at http://www.ttc.lv/New/lv/tulkojumi/E0040.doc)(but not the most recent version)
Latvian Labor Law	(English translation available at http://www.ttc.lv/New/lv/tulkojumi/E0223.doc)
Latvian Group of Companies Law	(English translation available at http://www.ttc.lv/New/lv/tulkojumi/E0100.doc)
Russia: Principal Laws	
APC	Russian Administrative Procedure Code
CC	Civil Code of the Russian Federation
KoAN	Russian Code of Administrative Violations
Criminal Code	
JSC Law	Russian Law on Joint Stock Companies
Labor Code	
Bankruptcy Law	
OOO Law	Russian Law on Limited Liability Companies
Capital Market Law	Russian Law on the Capital Market
Russia: Abbreviations	
CCMD	Center for Capital Market Development (Russia)
FSFM	Federal Financial Markets Service
OAO	Open joint stock company
OOO	Limited liability company
ZAO	Closed joint stock company
United Kingdom: Principal Laws	
Companies Act 1985	Law on companies presently in force in the U.K.
Companies Act 2006	New law on companies, adopted in late 2006, to come into force in 2008, at which time it will replace the Companies Act 1985.
Insolvency Act 1986	
Tables A-F	Default terms for a company charter under the Companies Act 1985 are contained in Tables A-F, which accompany the Companies Act. See Companies Regulations 1985 (SI 1985/805).
UK: Abbreviations	
A.C.	Appeal Cases
ACSR	Australian Corporations and Securities Reports

BCC	British Company Cases
BCLC	Butterworths Company Law Cases
Ch.D	Chancery Division
CLR	Commonwealth Law Reports (from Australia)
D.L.R.	Dominion Law Reports (from Canada)
DTI	Department of Trade and Industry (UK)
E.R.	English Reports
EWCA Civ	England & Wales Court of Appeal Civil Division
EWHC	England & Wales High Court
NSWSC	New South Wales Supreme Court
W.L.R.	Weekly Law Reports
W.N. (N.S.W.)	Weekly Notes (New South Wales)
United States: Principal Laws	
Delaware General Corporation Law	(available at http://www.delcode.state.de.us/title8/index.htm)
ERISA	Employee Retirement Income Security Act of 1974
MBCA	Model Business Corporation Act (2002 version available at http://www.abanet.org/buslaw/library/onlinepublications/mbca2002.pdf)
Sarbanes Oxley Act	
Securities Act of 1933	(available at http://www.law.uc.edu/CCL/33Act/index.html)
Securities Exchange Act of 1934	(available at http://www.law.uc.edu/CCL/34Act/index.html)
US: Abbreviations	
A.2nd	Atlantic Reporter, 2nd series (includes Delaware cases)
CEO	Chief Executive Officer
CFO	Chief Financial Officer
D&O Insurance	Directors' and officers liability insurance
F.3d	Federal Reporter, third series (reports of federal appellate cases)
F. Supp.	Federal Supplement (reports of federal district court cases)
NASDAQ	National Association of Securities Dealers Automated Quotation System
SEC	Securities and Exchange Commission
U.S.C.	United States Code
Other Abbreviations	
ASIC	Australian Securities and Investment Commission
Other Sources	
IAS	International Accounting Standards (newer standards are known as International Financial Reporting Standards, or IFRS) Older IAS statements retain the IAS designation.

IFRS	International Financial Reporting Standards (older standards were known as International Accounting Standards, or IAS, and retain the IAS designation)

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