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)

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This Article contains chapters 8-9, 11-13, and the Conclusion of a World Bank-sponsored Report, prepared in December 2006, to the Russian Federal Service on the Securities Market. We discuss the liability under company law of directors, senior company officials, and controlling shareholders of public companies in Canada, France, Germany, Korea, Russia, the United Kingdom, and the United States (with a more limited look at Austria, the

European Union, Italy, Japan, and Latvia), and recommend amendments to Russian Company Law. We propose measures to 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; and protect directors against liability for business decisions adopted without a conflict of interest.

A related article includes chapters 1 and 3 of the Report, and an introduction to the overall project by Prof. Black. These chapters address the substantive bases for liability of directors and company officials for breach of duty. See Legal Liability of Directors and Company Officials Part 1: Substantive Grounds for Liability (Report to the Russian Securities Agency), 2007 COLUM. BUS. L. REV. 614 (2007), available at http://ssrn.com/abstract=1010306.

The full Report is available at http://ssrn.com/abstract=1001990 (English version) and http://ssrn.com/abstract=1001991 (Russian version). It also addresses duties of directors for a company in financial distress, duties of a managing organization, the role of labor law in governing the relationship between a company and its directors and officials, whether this relationship is contractual or legal in nature, and differences between public and nonpublic companies.

OVERVIEW OF PART 2

Bernard Black**

This Article is Part 2 of a two-part article, which contains selected Chapters of a World Bank sponsored Report on reforms of Russian company law, delivered in December 2006 to the Russian securities agency, known as the Federal Service for Financial Markets (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*. The Report provides a detailed comparative analysis of Russia's current law and the laws of several common law countries (Canada, United Kingdom, United States) and civil law countries (France, Germany, Korea), plus a more limited look at the European Union and several additional countries (Austria, Italy, Japan, and Latvia). It then offers detailed recommendations for reform of Russia's company law. The Report was prepared for the *IOS Partners* consultancy in Coral Gables, Florida. For an overview of the Report, and the Russian context in which it was prepared, see my Introduction to the Report, included in Part I.

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

** 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.

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, 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, they have asked me to emphasize that the recommendations were prepared by me and Linia Prava. Their responsibility is limited to the specific country discussions which they prepared.

The Table of Contents below indicates, for each chapter of the underlying Full Report, whether the chapter is included in Part 1, in this Part 2, or only in the Full Report.

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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.[1] 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

[1] *See, e.g.*, 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 A08-5583/03-4); 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).

have the right to file a derivative action. In particular creditors do not have this right. Judicial precedent supports this opinion.[2]

Jurisdiction: regular courts or arbitrazh courts?

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.[3] 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

[2] 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»).

[3] 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).

sometimes have to rectify instances of improper acceptance of jurisdiction by lower courts.[4]

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.[5]

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 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

[4] *See, e.g.*, 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 A09-7324/04-10).

[5] 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»).

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.[6]

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. Two 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

[6] 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).

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.[7] 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 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

[7] Decision of the Federal Arbitrazh Court of the Moscow District No. KG-A40/1768-06-P (Mar. 14, 2006 and Mar. 16, 2006) (Постановление Федерального Арбитражного Суда Московского Округа от 16.03.2006, 14.03.2006, № КГ-А40/1768-06-П).

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.[8]

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.[9] 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.

[8] Y.V. Romanova, *Protection of the Rights of Minority Shareholders in the Russian and Foreign Civil Law*, 8 THE LAWYER 34 (2004) (Ю.В. Романова *Защита прав миноритарных акционеров по российскому и зарубежному гражданскому прав*, Юрист).

[9] *See, e.g.*, G.O. Abolonin, *New Claims*, 11 ECON. & LIFE: THE JURIST (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.[10]

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

[10] *See* Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385, 1443-44 (2006), *available at* http://ssrn.com/abstract=438321.

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.[11]

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 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.

[11] *See* DENNIS H. PETERSON, SHAREHOLDER REMEDIES IN CANADA §§ 18.101.1, 18.235–18.237 (1989).

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.[12] 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,[13] 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.

[12] TERRÉ ET AL., LE DIREGEANT DE SOCIÉTÉ: RISQUES & RESPONSABILITÉS § 061-18 (2002).

[13] 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), art. 200, and shareholder associations (Loi no 94-679 du 8 août 1994).

> **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).

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.[14] The "collective" suit apparently has some cost advantages over suits brought by individual shareholders.[15]

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[14] Décret no 67-236 sur les sociétés commerciales (as amended), art. 200.

[15] FRANCIS LEFEBVRE, MÉMENTO SOCIÉTÉS COMMERCIALES § 8516 (2006).

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,[16] 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.[17]

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.[18] This action has been summarized as follows:

> 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 can receive damages, restitution, and recovery of legal costs. Although an *action civile* is generally reserved

[16] *See, e.g.*, FRANCOIS BASDEVANT, ANNE CHARVERIAT & FRANCOISE MONOD, LE GUIDE DE L'ADMINISTRATEUR DE SOCIÉTÉ ANONYME 185 (2d ed. 2004).

[17] PHILIPPE MARINI, LA MODERNISATION DU DROIT DES SOCIÉTÉS. RAPPORT AU PREMIER MINISTRE (1996).

[18] *See* PHILIPPE MERLE, DROIT COMMERCIAL, SOCIÉTÉS COMMERCIALES § 416 (9th ed. 2003).

> 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.[19]

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.[20] 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.[21] 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.

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[19] Christopher D. Van Blarcum, *Internet Hate Speech: The European Framework and the Emerging American Haven*, 62 WASH. & LEE L. REV. 781, 798 (2005).

[20] Code de Commerce 2000, art. L. 238-1, changed by Ordonnance no 2004-604 du 24 juin 2004.

[21] Loi no 2003-706 du 1er août 2003, art. 136 which amends Code monétaire et financier 2000, art. L. 452-1; *cf.* Code de Commerce 2000, arts. L. 225-120, 225-252.

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;
- 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 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 the company on whose behalf the case is brought.[22]

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.

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

[22] Case No. 2003-Da-49221.

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.[23]

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.

[23] The demand is generally made through a letter to the director and, at the same time, filed with the court.

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 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 U.K. at the moment. The basic position in English law is that directors' and managers' duties are owed to the

company.[24] As a result, the company is the proper plaintiff to bring an action claiming that there has been a breach of duty.[25]

"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.[26] 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—
> (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,[27] or

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[24] Percival v. Wright, [1902] 2 Ch. 421.

[25] Foss v. Harbottle, [1843] 2 Hare 461.

[26] *See generally* Law Comm'n for England & Wales, *Shareholder Remedies*, Consultation Paper No. 142 (Oct. 22, 1996); Law Comm'n for England & Wales, *Shareholder Remedies*, Final Report No. 246 (Oct. 24, 1997).

[27] 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.

(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 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.[28]

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.[29] 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.[30]

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[28] Cheffins & Black (2006), *supra* note 10.

[29] Atwool v. Merryweather, [1867] 5 L.R. Eq. 464n; Prudential Assurance Co. v. Newman Indus. Ltd. (No. 2), [1981] Ch. 257 and [1982] Ch. 204; Barrett v. Duckett, [1995] 1 BCLC 243.

[30] HERBERT SMITH, SURVEY RELATED TO DIRECTORS DUTIES AND INSURANCE: SUMMARY REPORT (2006), *available at* http://www.herbertsmith.com/Publications/archive/2006/DirectorsDutiesSummaryReportJuly2006.htm.

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.[31]

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 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

[31] For details, see WILLIAM ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION, ch. 10 (2d ed. 2007).

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.[32]

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

[32] Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996), *available at* http://ssrn.com/abstract=10037.

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.[33]

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.

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.[34]

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[33] *See, e.g.*, Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991).

[34] 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 & Michael Sekyra, *No Derivative Shareholder Suits in Europe - A Model of Percentage Limits, Collusion, and Residual Owners* (Columbia Law & Economics Working Paper No. 312, 2006), *available at* http://ssrn.com/abstract=933105.

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 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 shareholder's shares at an above-market price. We therefore recommend that a 1% shareholding requirement be added to JSC Law art. 84.

Based on experience with 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 case, 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 costs, 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.[35]

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

[35] NAT'L COUNCIL ON CORPORATE MGMT., OUTLINE OF THE DEVELOPMENT OF CORPORATIVE LEGISLATION FOR 2008 («Концепция развития корпоративного законодательства на 2008 год», подготовленная Национальным Советом по Корпоративному Управлению), *available at* http://corp-gov.ru/bd/db.php3?db_id=3444&base_id=3.

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 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)).[36] 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 United States, 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.[37] These rules would be evaded by a collusive settlement. Thus, if a collusive settlement can be shown to have been made, it

[36] For discussion see William Kaplan & Bruce Elwood, *The Derivative Action: A Shareholder's 'Bleak House'*, 36 U. BRIT. COLUM. L. REV. 443, 477 (2003).

[37] CA Paris 14 mai 1982, BRDA 1982/17, at 11.

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 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.[38] 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

[38] 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 ed. 2006).

> 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.

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.[39] 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.[40] 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 discussion of these reforms in

[39] Barrett v. Duckett, [1995] 1 BCLC 243.

[40] *See* Law Comm'n for England & Wales, *Shareholder Remedies*, Consultation Paper No. 142, § 17.10 (Oct. 22, 1996); Law Comm'n for England & Wales, *Shareholder Remedies*, Final Report No. 246, § 6.107 (Oct. 24, 1997).

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.[41] 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 United States, 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.[42]

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

[41] Law Comm'n for England & Wales, *Shareholder Remedies*, Final Report No. 246, § 6.107 (Oct. 24, 1997), annex containing draft Civil Procedure Rule 50.

[42] 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 COLUM. L. REV. 669 (1986).

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.[43]

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'

[43] *See* Michael Perino, *Institutional Activism through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions* (St. John's Legal Studies Research Paper No. 06-0055, 2006), *available at* http://ssrn.com/abstract=938722.

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 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. This will 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.[44]

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.

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,

[44] We discuss which courts have jurisdiction over these disputes *supra* in subchapter 8.1.

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.[45] 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

[45] For discussion of the powers of the Australian Securities and Investment Commission under Australian law, see Cheffins & Black (2006), *supra* note 10, at 1433-41.

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.[46]

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

[46] *See* Order of the Federal Financial Markets Service No. 06-68/pz-n "On the Acceptance of the Sub-law on the Organizational Operations on Trade on the Stock Market" (June 22, 2006) (establishing listing requirements) (Приказ Федеральной Службы по Финансовым Рынкам от 22 июня 2006 г. N 06-68/пз-н «Об утверждении положения о деятельности по организации торговли на рынке ценных бумаг»).

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 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).[47] 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

[47] We discuss the concept of losses in subchapter 1.7.

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.

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.[48]

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.[49]

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.[50] However, D&O insurance, which has become more common

[48] MCCARTHY TETRAULT, DIRECTORS' AND OFFICERS' DUTIES AND LIABILITIES IN CANADA 296 (1997).

[49] *Id.* (discussing Chromex Nickel Mines Ltd. v. British Columbia (Securities Commission), [1991] 4 Bus. L.R.2d 189).

[50] 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 no. 540 (1995); ESTELLE SCHOLASTIQUE, LE DEVOIR DE DILIGENCE DES ADMIISTRATEUR DE SOCIETES. DROITS FRANÇAIS ET ANGLAIS nos. 249, 255 (1998).

in recent years (see the discussion in subchapter 9.2), can be used to cover both damages and legal expenses.[51] 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.[52]

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).[53] In a joint stock company, these payments must be authorized by the board of directors.[54] 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

[51] Joël Monnet, *Assurance de responsabilité – Dirigeants sociaux,* JURISCLASSEUR SOCIETES TRAITE, Fasc. 132-15, no. 36 (Aug. 2003).

[52] Yves Guyon, *Administration – Responsabilité civile des admiistrateurs,* JURISCLASSEUR SOCIETES TRAITE, Fasc. 132-10, no. 129 (Oct. 2005).

[53] GIBIRILA (1995), *supra* note 50, no. 161; Dominique Bureau, *Administration – Rémunération des administrateur,* JURISCLASSEUR SOCIETES TRAITE, Fasc. 130-40, no. 36 (Feb. 1999).

[54] Décret no. 67-236 du 23 mars 1967 sur les sociétés commerciales, art. 93(2).

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.[55] 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.

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.[56] 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

[55] Dominique Bureau, *Administration – Contrats entre les administrateurs et la société,* JURISCLASSEUR SOCIETES TRAITE, Fasc. 130-50, no. 116 (Dec. 2004).

[56] 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.

directors' liability to third persons is a decision to indemnify the directors permitted.[57]

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.[58] 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 he is acting lawfully

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[57] *See, e.g.*, 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 84 (Wolfgang Hefermehl & Gerald Spindler), ¶ 74 (Bruno Kropff & Johannes Semler eds., 2d ed. 2004); GROßKOMMENTAR ZUM AKTIENGESETZ § 93 (Klaus Hopt), ¶ 515 (4th ed.1999); KÖLNER KOMMENTAR ZUM AKTIENGESETZ § 84 (Hans-Joachim Mertens), ¶¶ 76, 81 (1996).

[58] BASTUCK, ENTHAFTUNG DES MANAGEMENTS 102 *et seq.* (1986); DIE HAFTUNG DER LEITUNGSORGANE VON KAPITALGESELLSCHAFTEN 73-4 (Schlechtriem) (Kreuzer ed., 1991); Hefermehl & Spindler in MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 84 (2004), *supra* note 57, ¶ 74.

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.[59]

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.[60]

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

[59] Hopt in GROßKOMMENTAR ZUM AKTIENGESETZ § 93 (1999), *supra* note 57, ¶ 516; Mertens in KÖLNER KOMMENTAR ZUM AKTIENGESETZ § 84 (1996), *supra* note 57, ¶ 76.

[60] *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."

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.
>
> **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."[61] The Model

[61] DEL. CODE ANN. tit. 8 [hereinafter DEL. GEN. CORP. LAW], § 145(a) (2007), which 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

Business Corporation Act provides even broader rights to indemnification.[62]

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.[63] But damage awards against directors are rare, because of the separate 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).[64] 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.

(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 . . . ." *Id.* § 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.

[62] 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) (2007); *see also id.* §§ 8.51(a), 8.53, 8.58(a).

[63] DEL. GEN. CORP. LAW § 145(b) (2007) 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."

[64] *Id.* § 102(b)(7).

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.[65] 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.[66] 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

[65] These bylaws are expressly permitted by *id.* § 145(f). *See also* MODEL BUS. CORP. ACT § 8.58(a) (2007).

[66] *See* DEL. GEN. CORP. LAW § 145(c) (2007); MODEL BUS. CORP. ACT § 8.52 (2007).

significant assets, and could not repay the advanced expenses once he had been sentenced.[67]

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 analysis, there are occasional court battles between a company and an officer over indemnification, but none involving outside directors.[68]

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.

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[67] Bergonzi v. Rite Aid Corp., No. 20453-NC, 2003 Del. Ch. LEXIS 117 (Del. Ch. Oct. 20, 2003).

[68] For an example of the former, see Fasciana v. Elec. Data Sys. Corp., 829 A.2d 178 (Del. Ch. 2003).

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."[69]

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."[70] 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 the Act."[71] A company is under no such obligation, however, if

[69] *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005), *aff'd*, 906 A.2d.27 (Del. 2006).

[70] Regulation S-K, 17 C.F.R. § 229.510 (2006).

[71] *Id.* § 229.512(h)(3). In practice, all companies that register securities seek to accelerate the effective date of the registration.

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 thirty 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.[72]

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

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[72] In Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 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 $5000 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 L.J. 1153, 1161-64 (1973) (stating reasons why a court could find no inconsistency with public policy).

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 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 place.

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:

> 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.][73]

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

[73] Cheffins & Black (2006), *supra* note 10, at 1406-07.

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.[74] 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).

[74] *See* Mark Landler, *Six in Germany Settle Landmark Case on Bonuses*, N.Y. TIMES, Nov. 25, 2006.

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.

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 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 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 gone bankrupt. Directors of solvent companies, who were insured by the same insurance company, would have faced similar risk, were it not for the availability 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 November 27, 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.[75] Directors' and officers' insurance is still a relatively new phenomenon in France. However, almost 94% of large firms have such insurance.[76]

French insurance law specifically permits D&O insurance contracts, but also imposes some restrictions on the terms of insurance.[77] 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.[78] This provision is considered mandatory law.[79] Furthermore, the insurer may only pay a person who

[75] Monnet (2003), *supra* note 51, no. 36.

[76] *Id.* no. 13.

[77] 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.

[78] *Cf.* GIBIRILA (1995), *supra* note 50, no. 525.

[79] Monnet (2003), *supra* note 51, no. 30.

suffered damage, from which a causal link to the insured person's actions can be established.[80] 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 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 be subject to that provision), it is unclear whether Article L. 225-38 applies.[81] 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.[82] The same argument applies to lawsuits brought

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[80] Code des Assurances arts. L. 124-1, 124-3. *See* Monnet (2003), *supra* note 51, no. 28.

[81] *See* TERRÉ ET AL. (2002), *supra* note 12, no. 008-06 (suggesting that the provision is applicable); Monnet (2003), *supra* note 51, no. 22 (arguing against applicability).

[82] Charles Freyria, *L'assurance de responsabilité civile du »management«*, 1995 RECUEIL DALLOZ SIREY, CHRONIQUE 120, 121-22 (1995); Monnet (2003), *supra* note 51, no. 24.

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.[83]

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)[84] drafted standard terms for D&O insurance. However, the terms which are used in practice are said to be very diverse.[85]

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. Currently, it is the unanimous view of commentators that in general D&O insurance for board members is permissible.[86] Insurance for officers who are not members of the

[83] Monnet (2003), *supra* note 51, no. 26.

[84] The English version of the GDV's website is located at http://www.gdv.de/English/index.html.

[85] *See* Michael Vothknecht, *Die "wissentliche Pflichtverletzung"*, in DER VERMÖGENSSCHADEN-HAFTPFLICHT-/D&O-VERSICHERUNG, *PHi* 2/2006, 52-63, *available at* http://www.genre.com/sharedfile/pdf/PHi20062_Pflicht-verletzung-de.pdf.

[86] *See, e.g.*, HÜFFER (2006), *supra* note 34, at § 84, ¶ 16; § 113, ¶ 2a; Hopt in GROßKOMMENTAR ZUM AKTIENGESETZ § 93 (1999), *supra* note 57, ¶ 520; Hefermehl & Spindler in MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 93 (2004), *supra* note 57, ¶ 93.

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.[87] 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.[88] 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

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[87] HÜFFER (2006), *supra* note 34, at § 113, ¶ 2a; Kästner, *AG* 2000, 113, 118.

[88] Johannes Semler, in MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 116 (2004), *supra* note 57, ¶ 777; Hopt in GROßKOMMENTAR ZUM AKTIENGESETZ § 93 (1999), *supra* note 57, ¶ 519; Hans-Joachim Mertens, *Bedarf der Abschluss der D&O-Versicherung durch die AG der Zustimmung der HV?*, 2000 DIE AKTIENGESELLSCHAFT 447, 451; Meinrad Dreher, *Der Abschluss von D&O-Versicherungen und die aktienrechtliche Zuständigkeitsordnung*, 165 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS-UND WIRTSCHAFTSRECHT 293, 313, 315 (2001).

company,[89] the insurance contract should provide for a deductible, so that the directors have some residual amount of personal monetary liability.[90]

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.[91] Apart from that, 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,[92] 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.[93] Not coincidentally, the Korean D&O insurance market took off at the same time. Insurance is considered

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[89] In general, this type of insurance for the account of a third party is possible. *See* Law on Insurance Contracts (VVG) § 74.

[90] Hefermehl & Spindler, in MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 93, (2004), *supra* note 57, § 93, ¶ 94.

[91] Law on Insurance Contracts (VVG) § 152.

[92] In particular, D&O insurance can protect the company against the insolvency of the directors; *see* Semler, in MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 116 (2004), *supra* note 57, ¶ 775; Hopt, in GROßKOMMENTAR ZUM AKTIENGESETZ, *supra* note 57, ¶ 519; Kurt Kiethe, *Persönliche Haftung von Organen der AG und der GmbH - Risikovermeidung durch D&O-Versicherung?*, 2003 BETRIEBS-BERATER 537, 539; Jobst-Hubertus Bauer &Jerome Krets, *Gesellschaftsrechtliche Sonderregeln bei der Beendigung von Vorstands und Geschäftsführerverträgen*, 2003 DER BETRIEB 811, 814.

[93] *See* Hwa-Jin Kim & Daniel Yi, *Directors' Liabilities and the Business Judgment Rule in Korea*, (working paper, 2004), *available at* http://ssrn.com/abstract=530442.

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.

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 $5000 per incident, so that a director or officer who is liable for damages must, in principle, pay the first $5000 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.[94] D&O insurance covers directors' legal expenses, damages paid pursuant to

[94] *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), *available 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).

judgment, and amounts paid in settlement. In contrast to indemnification, neither corporate law[95] nor securities law[96] places limitations on the permissible scope of D&O coverage.[97]

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[95] 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 . . . .

See also MODEL BUS. CORP. ACT § 8.57 (2007).

[96] 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 Bishop (1973), *supra* note 72, at 1161-64 (explaining why a court could find that use of insurance to cover claims under the securities laws is consistent with public policy).

[97] Under common law, courts will not permit recovery under insurance policies when the result would contravene public policy. For instance, in Level 3 Commc'ns Inc. v. Fed. Ins. Co., 272 F.3d 908 (7th Cir. 2001), and Conseco Inc. v. Nat'l Union Fire Ins. 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, *available 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*

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."[98] 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.[99] 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."[100]

Actions Seeking Return of Ill-Gotten Gains, 33 Sec. Reg. L.J. 162, 167-68 (2005).

[98] 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 ed. 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); OLSON & HATCH (2003), *supra* note 94, at § 12.12.

[99] 2 KNEPPER & BAILEY (2005), *supra* note 98, at § 25.03; MATHIAS ET AL. (2003), *supra* note 98, at § 8.04; Olson & Hatch (2003), *supra* note 94, at § 12.12; *see also* MODEL BUS. CORP. ACT § 8.57 cmt. (2007) (noting that D&O policies "typically do not cover . . . dishonesty, self-dealing, bad faith, knowing violations of [law], or other willful misconduct").

[100] *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005), *aff'd*, 906 A.2d.27 (Del. 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 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.[101]

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

[101] We discuss the jurisdiction of the regular and arbitrazh courts *supra* in Chapter 8.

consideration of the company's interests,[102] while in another it pointed to the apparent complete disinterest of the members of the company's management organs in fulfilling their duties.[103] Additional examples could be provided where management organ members were found liable for damages that they caused to a company.[104] These judgments, however, are more the exception than the rule and occur only occasionally.

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.

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[102] 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).

[103] 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).

[104] *See, e.g.*, Decision of the Federal Arbitrazh Court of the Western Siberian District No. F04-3476/2006 (23459-A75-16) (June 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).

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.[105] 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.[106]

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

[105] The Canadian Supreme Court has recently cast doubt on this proposition with the duties of care, skill and diligence. *See* People's Dep't 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.

[106] Cheffins & Black (2006), *supra* note 10, at 1445-47.

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 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.[107]

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.[108]

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).

[107] *See, e.g.*, Can. Automatic Data Processing Servs. Ltd. v. CEEI Safety & Sec. Inc., [2004] 192 O.A.C. 152; Proulx v. Sahelian Goldfields Inc., [2001] 55 O.R.3d 775.

[108] Cheffins & Black (2006), *supra* note 10, at 1474-75.

Germany

As the empirical evidence compiled by Brian Cheffins and Bernard Black shows, litigation against outside directors has been rare in Germany.[109] 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.

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

[109] *Id.* at 1420-33.

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.[110] 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

[110] Case No. 2003-Gahap-1176.

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.)[111]

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.[112]

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

[111] *See* Bernard Black, Barry Metzger, Timothy O'Brien & Young Moo Shin, *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness*, 26 J. CORP. L. 546, 579-80 (2001), *available at* http://ssrn.com/abstract=222491.

[112] *See* Cheffins & Black (2006), *supra* note 10, at 1399-1420, 1470-72.

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.

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.[113] 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*, 84 TEX. L. REV. 1385, 1392-98 (2006), which in turn summarizes the research on the United States in Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (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 WorldCom convicted of fraud, to surrender nearly all of his personal fortune—about $40 million—to investors who lost billions when the

[113] Equitable Life Assurance Soc'y v. Bowley, [2004] 1 BCLC 180.

company went bankrupt.[114] 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, 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 United States pay their own legal expenses, regardless of whether they win or lose in court.[115] 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 United States, 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

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[114] 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 COLUM. L. REV. 1534, 1552-53 (2006) (arguing, however, that insiders do not make personal payments often enough or large enough for civil liability to constitute a meaningful deterrent to misconduct).

[115] 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 COLUM. L. REV. 669, 670 n.2 (1986). In the United States, 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.

available for a securities lawsuit brought by investors against directors, and most securities suits are framed as class actions.[116] 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."[117] 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.[118]

With the setting for lawsuits thus made congenial, shareholder litigation is common in the United States. Between 1991 and 2004, 3263 federal securities class action cases were filed in U.S. federal courts, an average of just over 230 each year.[119] A

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[116] For a summary of class certification under the Federal Rules of Civil Procedure, see CHRISTOPHER HODGES, MULTI-PARTY ACTIONS 206–07 (2001).

[117] 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 *supra* in chapter 8.

[118] ROBERT W. HAMILTON, THE LAW OF CORPORATIONS IN A NUTSHELL 540–41 (5th ed. 2000).

[119] ELAINE BUCKBERG, TODD FOSTER, RONALD MILLER & STEPHANIE PLANCICH, NERA ECON. CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: BEAR MARKET CASES BRING BIG SETTLEMENTS 2 (2005). NERA reports that 1897 of these cases had been settled as of year-end 2004.

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.[120]

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.[121] 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.[122]

Our study of outside director liability in the United States 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

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[120] Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 168-69 (2004).

[121] 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 Thompson & Thomas (2004), *supra* note 120, at 133-209, but could be on the order of twenty 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).

[122] Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006), *available at* http://ssrn.com/abstract=894921.

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.[123]

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 United States. 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 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."[124] 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.[125]

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[123] These fourteen instances of out-of-pocket liability involved thirteen companies. The Enron directors paid to settle both a securities case and an ERISA case.

[124] *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

[125] *See id.* at 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 BUS. CORP. ACT § 2.02 (2007), the Model Business

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.[126]

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" pattern; a fifth might do so.[127] However, this scenario should not be a substantial concern for outside directors today, assuming a public company has a

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Corporation Act (MBCA) provision authorizing corporations to limit or eliminate the personal liability of a director.

[126] *See* KNEPPER & BAILEY (2005), *supra* note 98, § 22-12 ("Contracts, bylaws or charter provisions frequently provide for indemnification 'to the fullest extent permitted by law.'").

[127] On the actual cases and for a broader examination of the "Can't Afford to Win" scenario, see Black, Cheffins & Klausner (2006), *supra* note 122, at 1109-10.

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.[128]

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

[128] On the "Perfect Storm" scenario, see *id.* at 1113-18.

wealth, aligned with culpability, so that the plaintiffs can expect to recover more by going to trial than by settling within policy limits.[129] 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 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."[130] 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.[131]

The Enron and WorldCom securities fraud settlements were quickly heralded as "legendary."[132] John Coffee, a Columbia law professor, said the "explicit agenda of requiring a personal contribution

[129] 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.

[130] Press Release, Office of the N.Y. State Comptroller, Hevesi Announces Historic Settlement, Former WorldCom Dirs. to Pay from Own Pockets (Jan. 7, 2005).

[131] *See* Ben White, *Former Directors Agree to Settle Class Actions; Enron, WorldCom Officials to Pay Out of Pocket*, WASH. POST, Jan. 8, 2005, at E1 (quoting plaintiffs' counsel, William Lerach, saying the settlement will "send a message").

[132] Roger Eabee, *Director Shortage? No Way*, FIN. EXECUTIVE, May 2005, at 38.

ha[d] traumatized outside directors."[133] 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.[134] 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 United States, 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.[135] 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

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[133] John C. Coffee, Jr., *Hidden Issues in 'WorldCom,'* NAT'L L.J., Mar. 21, 2005, at 13.

[134] *See* Black, Cheffins & Klausner (2006), *supra* note 122, at 1080-81.

[135] 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 EUR. FIN. MGMT. 153, 161 (2005), *available at* http://ssrn.com/abstract=682507.

> damages in excess of the D&O insurance coverage.[136] 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.[137] 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.[138]

> 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

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[136] 488 A.2d 858, 864 (Del. 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* Symposium, *Theory Informs Business Practice: Roundtable Discussion: Corporate Governance*, 77 CHI.-KENT L. REV. 235, 238 (2001) (quoting Robert Pritzker, a controlling shareholder of the acquiring company).

[137] *See* HAMILTON (2000), *supra* note 118, at 562-74 (summarizing the key aspects of these two Acts).

[138] Cheffins & Black (2006), *supra* note 10, at 1399, 1475-77.

and because class actions are difficult to launch. There are, however, various key common themes across borders:

(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 they arise.

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 United States involved companies cross-listed in the United States (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 United States, 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.
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> 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.[139]

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[139] 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 ed., 2006), *available at* http://ssrn.com/abstract=628223.

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.

CHAPTER 12. ADMINISTRATIVE LIABILITY OF DIRECTORS AND MANAGERS

Subchapter 12.1. Administrative offenses 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 offenses?

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.[140]

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	fine of 50-100 times the minimum monthly wage disqualification for 6 months-2 years

[140] 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)).

	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.	
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 1000 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 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 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.[141]

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.

[141] 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)).

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*[142] 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.

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.

[142] English version available at http://195.83.177.9/code/liste.phtml?lang=uk&c=25.

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 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.[143]

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:[144]

> 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.[145] To check for

[143] *See, e.g.*, THE ENCYCLOPEDIA OF FINANCIAL SERVICES LAW (Eva Lomnicka and John L. Powell eds., 2004).

[144] Black, Cheffins & Klausner (2006), *supra* note 122, at 1131-35 (only selected footnotes included).

[145] *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 AM. CRIM. L. REV. 877, 927 (2005).

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.[146]

At the same time, SEC officials have publicly stated that a number of ongoing SEC investigations include outside directors.[147] 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

[146] In SEC v. Excal Enters., 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.

[147] *See* Remarks by Alan Beller, Head of SEC Div. of Corp. Fin., ABA Webcast (Dec. 14, 2005), http://www.connectlive.com/events/secadvisory1205. Several interviewees also told us about these investigations.

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.[148] 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]."[149] For

[148] 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).

[149] 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 of Investigation Pursuant to Section 21(A) of the

the SEC to show unfitness, it must demonstrate a likelihood that the misconduct will be repeated.[150] 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.[151]

In sum, while careless or incompetent outside directors face theoretical financial risk due to SEC

Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & 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 & 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).

[150] *See* SEC v. Patel, 61 F.3d 137, 141-42 (2d 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 N.C. L. REV. 1489 (1992).

[151] *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), *available at* http://www.sec.gov/litigation/litreleases/lr18104.htm. For citations to officer-director bar cases against *insiders*, see 10 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION §§ 5087-92 (3d ed. 1989).

> 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.

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. We do recommend, in subchapter 12.2, that the FSFM be given the power to obtain a court order which bars 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 proof of a serious breach of duty to a public company.

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 imposing administrative liability on members of company management organs?

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.[152] Upon discovering administrative offenses, the FSFM compiles a report (Code of Administrative Offenses art. 28.5) and must examine the case within fifteen days (Code of Administrative Offenses art. 29.6). No court hearing is provided for examining disputes in these cases.

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.[153]

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 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

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[152] 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»)*.

[153] *See, e.g.*, MARK R. GILLEN, SECURITIES REGULATION IN CANADA 503-11 (2d ed. 1998).

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, 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, 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.

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 arts. L. 621-9 (power to carry out inspections and investigations); L. 621-10 (request sight of any document); and 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.[154] A person who is found liable has the right to appeal to court.[155]

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* (Finanzdienstleistungsaufsichts-gesetz), or Act on Supervision of Financial Services (which establishes the BaFin), the *KWG* (Kreditwesengesetz), or Banking Act,[156] and the German Securities Trading Act (WpHG).[157] In general, issues of company law do not lie within the responsibility of the BaFIN. See, for example

[154] 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.

[155] For the complicated issues regarding the proper procedure see Nicole Decoopman, *Autorité des Marchés Financiers – Pouvoir de sanction,* JURISCLASSEUR SOCIETES TRAITE, Fasc. 1511 (2004).

[156] A somewhat dated English translation is available at: http://www.ius comp.org/gla/statutes/KWG.htm.

[157] A current English translation can be found on the BaFIN home page at: http://www.bafin.de/gesetze/wphg_en.htm.

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.

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 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			
Country	**Bring Civil Action for Damages**	**Seek Administrative Penalties**	**Seek Criminal Sanctions**	**Prosecutor can Obtain Criminal Sanctions**[158]
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[159]
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

[158] We discuss criminal sanctions *infra* in chapter 13.

[159] As discussed *infra* 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.

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.

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 long as its powers to investigate breach of duty under company law are 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 sactions 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:[160]

> 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.[161]

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[160] Cheffins & Black (2006), *supra* note 10, at 1391.

[161] 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], art. 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 INT'L COMPANY & COM. L. REV. 490, 499 (2005). For Australia, see R.P. AUSTIN,

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

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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. 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 United States, 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).

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.

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 offenses?

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	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

Offense	**Constituent elements**	**Penalty** (depends on severity)
	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	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. 177)	*Deliberate evasion* of the repayment of substantial debts or of the payment for securities, after entry of an appropriate court judgment	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)
		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	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,

Offense	**Constituent elements**	**Penalty** (depends on severity)
	information, or the issuance of securities without state registration, if such actions have inflicted substantial damage to citizens, organizations, or the State	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[162]

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

[162] Under Criminal Code art. 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.

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.

France

With respect to criminal liability, there are specific provisions in 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* or 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 be a financial interest.[163]

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.[164]

For failure to disclose, 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).

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.[165]

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*)

[163] Cass. crim., June 19, 1978, Bull. crim., No. 202; March 20, 1997, RJDA 10/97, No. 1207.

[164] PAUL LE CANNU, DROITS DES SOCIETES § 278 (2d ed. 2003).

[165] An English translation of this law can be found on the BaFIN home page at: http://www.bafin.de/gesetze/wphg_en.htm.

under StGB §266(1)[166] 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.[167] 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.[168]

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

[166] 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."

[167] Federal Supreme Court (BGH) 21.12.2005 - Az: 3 StR 470/04, NJW 2006, 522.

[168] Cheffins & Black (2006), *supra* note 10, at 1472.

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 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) causes 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 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.[169] The Steering Group said this occurred principally through two channels. First, the threat of criminal sanctions influences directors' behaviour directly. 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.[170] 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.[171] 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

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[169] *See* CO. LAW REVIEW, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: COMPLETING THE STRUCTURE ch. 13 (Department of Trade and Industry, 2000); CO. LAW REVIEW, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY – FINAL REPORT ch. 15 (Department of Trade and Industry, 2002).

[170] *See* LAW COMM'N, COMPANY DIRECTORS: REGULATING CONFLICTS OF INTERESTS AND FORMULATING A STATEMENT OF DUTIES § 10.2 (1998); *see also* DEP'T OF TRADE & INDUS., COMPANIES IN 2004-2005, Table D3 (2006), *available at* http://www.dti.gov.uk/files/file13424.pdf.

[171] *See* SIMON DEAKIN & ALAN HUGHES, DIRECTORS' DUTIES: EMPIRICAL FINDINGS – REPORT TO THE LAW COMMISSIONS (1999), *available at* http://www.lawcom.gov.uk/docs/study.pdf; *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), *available at* http://dti2info1.dti.gov.uk/cld/deakin_z.pdf.

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 § 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. They 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.[172]

In some cases, courts or the prosecution may request, or sometimes may be required to request an opinion from the AMF.[173]

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)[174] are applicable. For instance, its Article 132-24 states:

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[172] A similar provision is found in the French Code of Criminal Procedure (Code de Procedure Penale), art. 40(2).

[173] *See* Code de Commerce, art. 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.

[174] English translation available at http://195.83.177.9/upl/pdf/code_33.pdf.

> 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, 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:[175]

> (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

[175] English translation available at http://www.iuscomp.org/gla/statutes/StGB.htm (but not the most recent version).

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.

The punishments that can be imposed on directors for breaches of companies legislation 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.[176] 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 SEC 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

[176] Gouriet v. Union of Post Office Workers, [1978] A.C. 435, 481 (Lord Wilberforce).

activity. The FSFM will also have the ability to assist the prosecutor in bringing 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 bringing complex securities cases. The prosecutor therefore relies heavily on 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 TO THE REPORT

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 difficult road to developing world-class standards of corporate governance.

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