LEGAL LIABILITY OF DIRECTORS AND COMPANY OFFICIALS PART 1: SUBSTANTIVE GROUNDS FOR LIABILITY (REPORT TO THE RUSSIAN SECURITIES AGENCY)

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This Article contains chapters 1 and 3 of a World Bank-sponsored Report, prepared in December 2006, to the Russian Federal Service for the Financial Market (FSFM). 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. It includes an Introduction by Prof. Black which provides an overview of Russia's progress in creating a modern company law.

A related article includes chapters 8-9 and 11-13 of the Report, and addresses procedural rules for shareholder lawsuits and administrative and criminal liability of directors and company officials. See Legal Liability of Directors and Company Officials Part 2: Court Procedures, Indemnification and Insurance, and Administrative and Criminal Liability (Report to the Russian Securities Agency), 2008 COLUM. BUS. L. REV. (forthcoming 2008), available at http://ssrn.com/abstract=1010307.

The full Report is available at http://ssrn.com/abstract=1001990 (English version) and http://ssrn.com/

abstract=1001991 (Russian version). 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 THE REPORT

Bernard Black**

Background

This Article contains Chapters 1 and 3 of a World Bank sponsored Report on reforms of Russian company law, delivered in December 2006 to the Russian securities regulator, known as the Federal Service for the Financial Market (FSFM), and the Russian Center for Capital Market Development, under the longish title Comparative Analysis on Legal Regulation of the Liability of Members of the Board of Directors and Management Organs of Companies.[1] The Report provides a detailed comparative analysis of Russia's

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

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

current law and the laws of several common law or mostly common law countries (Canada, United Kingdom, United States) and several 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 recommends reforms of Russia's company law. The Report was prepared for the IOS Partners consultancy in Coral Gables, Florida.

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

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

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

of a "self-enforcing" law, strong on procedural protections against self-dealing, light on substantive prohibitions, and as light as we could make it in reliance on courts. Anna Tarassova and I were the principal drafters of the original 1995 law.[2] That law has since undergone major revisions in 2001 and 2006. I followed those reforms, albeit from a distance. I thus hopefully brought to this project close familiarity with the Russian company law, as well as my own sense of where the law had succeeded and failed. I also brought my strong view that, to be effective, company law must be adapted to local needs, not simply airlifted in from the United States or another developed country.

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

The process was sometimes painful, as my coauthors can attest. But it was also central to the value of this Report.

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

We needed to define questions that responded to the Russian concerns, yet were framed in a way that permitted comparative analysis. The effort to develop reform recommendations was similarly interactive. Alexandra Fasakhova and I discussed each question, the comparative experience, and potential reforms, and developed specific recommendations for each chapter and subchapter. I drafted, Linia Prava commented, I redrafted, CCMD commented, I redrafted again, and so on.

In every country, corporate governance depends on a complex set of regulations and market institutions, of which company law is only one.[3] Our Report addresses company law, and thus addresses only part of the overall system of Russian corporate governance. In preparing our recommendations, we tried to be sensitive to other Russian laws and institutions which affect corporate governance, and to the status of company law as part of a broader web of laws and institutions.[4] We also sought to be sensitive to the twin risks of under- and over-regulation. Russian companies need appropriate regulation, to give investors a basis for believing that the company is performing as disclosed, and that their funds will not be stolen by insiders. At the same time, over-regulated securities markets can raise, rather than lower,

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

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

companies' cost to raise capital.[5] As Russia's history teaches, government powers can be too great as well as too limited.

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

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

The partial success of the current company law is reflected in Russian share prices. Russia's total market capitalization is now approaching a trillion dollars.[6] This contrasts sharply to 1999, when $30 billion would have purchased all shares of every public Russian company, had the insiders' stakes been for sale at public trading prices.[7] The 1999 trading prices were often laughable—for example, $0.026 per barrel of oil reserves and gas equivalents for Gazprom, then and now the world's largest oil and gas company by reserves. Those deeply discounted prices

[5] For evidence that the Sarbanes-Oxley Act may have done exactly this, for both U.S. and foreign cross-listed companies, see Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross-Listed in the US*, 13 J. CORP. FIN. 195 (2007); Ivy Zhang, *Economic Consequences of the Sarbanes-Oxley Act of 2002*, J. ACCT. & ECON. (forthcoming 2008), *available at* http://ssrn.com/abstract=961964.

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

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

reflected the high risk that most or all value would be captured by controlling shareholders. That risk still exists today, but it has greatly receded. The overall "value ratio" (the ratio of the actual market capitalization of Russian firms to their estimated value at Western multiples) has risen from under 0.01 in 1999 to 0.10-0.20 today. The procedural controls on self-dealing transactions in the original Russian company law, which are central to our concept of a self-enforcing company law, surely deserve some of the credit.[8]

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

The success of company law is limited by the skill of the courts. Reinier Kraakman and I did our best to draft a company law that relied on the Russian courts as little as possible. This too was central to our concept of a self-enforcing law. Still, some basic degree of judicial honesty and competence is essential—perhaps more so than we

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

realized at the time. Unfortunately, the independence and skill of Russian judges remains in doubt. Judges are sometimes influenced by the views of government officials, and are susceptible to bribes or threats from powerful insiders.

But here too, matters are better than in 1995, when recourse to the courts was widely viewed as an exercise in futility. Jurisdiction over most company law disputes largely rests with the (more expert) "*arbitrazh*" or commercial courts, rather than the less expert general courts. Judicial decisions addressing the liability of directors and company officials remain limited, but no more so than in a number of the comparison countries. The Russian context portions of this Report include citations to forty-six Russian court decisions, a number from the Supreme Arbitrazh Court, the Supreme Court, or the combined Plenum of the Supreme Court and the Supreme Arbitrazh Court. This plenum can express its views on a variety of issues of legal interpretation which have proven troublesome to practicing lawyers or lower courts, even if these issues are not currently before these courts in a particular case. It has exercised this power on a number of occasions.[9]

Russia remains a country whose government has used tax claims and pliable courts to expropriate all shareholder value in one of the country's major companies (Yukos), and harassed both Russian and foreign lawyers who defended Yukos and its controlling shareholder, Mikhail Khodorkovski.[10] The Putin government has chased other

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

[10] For a (not very balanced) overview of Khodorkovski's criminal trial, see Otto Luchterhandt, *Legal Nihilism in Action: The Yukos-Khodorkovskii Trial in Moscow*, *in* THE UPPSALA YEARBOOK OF EAST EUROPEAN LAW 2005, at 3 (Kaj Hober ed. 2005). In reciting the Russian government's actions, I do not mean to defend Khodorkovski. On misdeeds by Khodorkovski and oligarchs, see Bernard Black, Reinier Kraakman & Anna Tarassova, *Russian Privatization and Corporate*

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

Scope of the Report

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

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

We limit our analysis to publicly traded companies.[15]

Governance: What Went Wrong?, 52 STAN. L. REV. 1731 (2000), *available at* http://ssrn.com/abstract=181348.

[11] Andrew Kramer, *Arrest Ordered for Russian Oil Entrepreneur, a Critic of the Kremlin*, N.Y. TIMES, Aug. 29, 2007, at C3.

[12] On Browder's role in Russian corporate governance, see John McMillan, *Gazprom and Hermitage Capital: Shareholder Activism in Russia* (Stanford Bus. Sch. Case IB-36, 2002).

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

[14] *See, e.g.*, Andrei Shleifer & Daniel Triesman, *A Normal Country*, 83 FOREIGN AFF. 20 (Mar.-Apr. 2004); ANDREI SHLEIFER, A NORMAL COUNTRY: RUSSIA AFTER COMMUNISM (2005). The Black-Kraakman-Tarassova work on Russian company law was part of a USAID funded Russian Legal Reform Project, directed by Prof. Shleifer.

[15] Chapter 10 of the Report considers which recommendations should also apply to open joint stock companies which are not publicly traded,

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

This Report is directed at company law reform in the context of Russia, its existing law, and its current needs. Nonetheless, its scope is quite broad. In theoretical ambition, it does not rival the comparative overview by Reinier Kraakman and coauthors.[16] But in scope it does. We know of no comparable resource on the key rules governing director and officer liability across a broad range of common and civil law countries. Our fine-grained review of key topics in company law can complement Kraakman et al., and hopefully advance comparative analysis of company law in both emerging and developed markets.

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

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closed joint stock companies, and limited liability companies. Here too, our reform suggestions were incremental, because Russia has a reasonably modern Law on Limited Liability Companies (adopted 1998), which draws in significant part on the JSC Law. I was an advisor on this Law, but not a principal drafter.

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

Structure of This Article and Its Companion

The overall Report runs to roughly 300 single-spaced pages. We decided to publish the elements that are most likely to be of interest outside Russia. That led to a two-part article, of which this is Part 1. Part 1 (Report Chapters 1 and 3) focuses on substantive liability rules under company law. Part 2 (Report Chapters 8 and 11-13) focuses on litigation procedures, shields against personal liability (indemnification and D&O insurance), administrative and criminal liability for breach of duty under the company law, and practical experience with actual liability. The remaining chapters are available in the full Report on SSRN, in both English and Russian. The table below summarizes where each portion of the full Report is available.[17]

Chapters of Full Report Included in Each Part

This table indicates, for each chapter of the underlying Full Report, whether the chapter is included in this Part 1, in Part 2, or only in the Full Report.

Ch.	Subch.	Chapter Title	In
		Overview (by Professor Black)	Part 1
		Introduction to the Report	Full

[17] Footnote numbers in each part will run consecutively, and therefore will not match footnote numbers in the full Report. Citation style in each part has been generally conformed to Bluebook style and differs from the style in the full Report. The original "Russian context" for each chapter was prepared by the Russian law firm of Linia Prava. Different lawyers prepared different sections, under the overall supervision of Alexandra Fasakhova. I substantially shortened the "Russian context" sections of the Report compared to the original Report as delivered to the FSFR, to improve readability for a non-Russian audience. The full version of the Russian context is available on request from Professor Black or Linia Prava. These technical differences aside, the substance of each part is identical to the original. The principal changes are to abbreviations and to the choice of English words used to convey Russian concepts. The text uses American English except in the discussion of Canada and the United Kingdom, where it uses British English (centre instead of center, and so on).

Ch.	Subch.	Chapter Title	In Report
1		*Conditions of civil liability of directors, members of a company's management organs, and controlling shareholders: key problems*	Part 1
	1.1	General context for each country	
	1.2	Concept of reasonableness and good faith	
	1.3	Should there be a presumption of reasonableness and good faith?	
	1.4	Concept of self-interest	
	1.5	Conflict of interest for transactions with controlling shareholder	
	1.6	Additional bases for the civil liability of company directors and managers	
	1.7	Damages for breach of duty	
2		*Legal nature of relationship between a director and a company*	Full Report
3		*Liability rules for different members of company management organs*	Part 1
4		*Application of labor law to members of company management organs*	Full Report
5		*Liability of managing organization (individual manager) and employees of managing organization*	Full Report
6		*Liability of directors and managers in the case of bankruptcy*	Full Report
7		*Particularities of liability for actions in respect of subsidiary and dependent companies*	Full Report
8		*Judicial proceedings in connection with liability of directors and managers*	Part 2
	8.1	Procedural points of liability of directors and managers	
	8.2	Prevention of abuses in bringing proceedings against members of	

Ch.	Subch.	Chapter Title	In
		company management organs	
	8.3	Powers of regulator in respect to judicial proceedings in connection with liability of members of company management organs	
9		*Insurance of liability of directors and managers and compensation of directors and managers by company*	
	9.1	Compensation of directors and managers by the company in suits and other proceedings	Part 2
	9.2	Insurance of liability of members of management organs	
10		*Particularities of liability of members of management organs of nonpublic companies*	Full Report
11		*Practical experience with liability for breach of duty under company law*	Part 2
12		*Administrative liability of directors and managers*	
	12.1	Administrative offences of directors and managers	Part 2
	12.2	Procedural aspects of administrative liability of members of company management organs	
13		*Criminal liability of members of company management organs*	
	13.1	Criminal offenses of members of company management organs	Part 2
	13.2	Procedural aspects of criminal liability of members of company management organs	
		Conclusion	Part 2
		Glossary of Specialized Terms	Part 1
		List of Principal Laws, Abbreviations, and Sources	Full Report

A Note on Russian Legal Structure and Terminology

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

CHAPTER 1. CONDITIONS OF CIVIL LIABILITY OF DIRECTORS, MEMBERS OF A COMPANY'S MANAGEMENT ORGANS, AND CONTROLLING SHAREHOLDERS: KEY PROBLEMS.

Subchapter 1.1. General context for each country

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

Russia

The primary provisions concerning the civil liability of the members of a company's management organs (the board of directors and the executive organ) can be found in the Civil Code and the JSC Law. The Civil Code norms apply only to the company's executive organs and its members. The JSC Law extends these norms to the board of directors and its

members. We will refer to the executive organ, the board of directors, and their members together as "governing entities." Unless otherwise specified, all references to laws and judicial decisions in the Russian Context portions of this Report are to laws and courts of the Russian Federation.

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

The elements of civil liability are:

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

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

3) the existence of culpable conduct.

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

A person's wrongful conduct (violation of the obligation to act reasonably, in good faith, and in the interests of the company), and the measure of culpability (lack of good faith) are separate criteria in determining liability, each of which should be established independently. For example, the burden of proving wrongful conduct lies with the plaintiff (e.g., the shareholder), but if the plaintiff can show wrongful conduct, the defendant has the burden of establishing the absence of culpability (Civil Code art. 401(2)).[1]

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

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

The JSC Law exempts the members of a management organ from liability if they voted against a decision resulting in losses to the company or did not participate in voting. JSC Law art. 71(4) establishes the joint and several liability of members of a collegial organ who are found liable (Civil Code art. 323 discusses the recovery procedures in this case). JSC Law art. 71(5) provides that a company—as well as shareholders holding in aggregate at least 1% of the company's outstanding common shares—have the right to file a suit against a governing entity (derivative suit).[2]

Austria

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

[2] We discuss derivative suits in Subch. 8.1.

Austrian corporate law, so case law is similar in the two countries as well.

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

Canada

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

Canada has a "federal" legal system, in which each province has authority to determine laws within its legislative competence, as specified in the Canadian constitution. There is a federal corporation law, the Canadian Business Corporation Act (CBCA), but this law is optional, rather than mandatory.[3] Each province also has its own corporation law, and firms can choose to be governed by one of these laws instead. However, the corporation laws of most provinces are similar to the CBCA. To simplify the analysis, this Report focuses on the CBCA and on the Ontario Business Corporations Act (OBCA).[4] The OBCA is deserving of special attention because Ontario is Canada's most heavily populated province, is the home of Canada's financial center (Toronto), and has larger and more active capital markets than other provinces.

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

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

European Union (EU)

European Union level company law consists of regulations (which apply directly to companies), directives

[3] The CBCA is available at http://www.canlii.org/ca/sta/c-44/.

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

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

At the level of the European Community, there is no voluntary Code of Corporate Governance similar to the codes found in individual countries such as Germany and the United Kingdom. However, the use of such codes is advocated in a 2005 Commission Recommendation, which also addresses the role of non-executive or supervisory directors of listed companies.[5]

Beginning in late 2004, European Union law provides for the possibility that a company can be formed as a European Company (SE). European companies can choose either a one-tier board structure, or a two-tier structure similar to that in Germany. The law on SE companies does not specify the duties of directors. Instead, these are determined by the law of the member state which is the company's principal location.[6] The European company form is gradually becoming more popular, but there are as yet extremely few judicial decisions interpreting the SE law.[7]

France

The law on French joint stock companies (*sociétés anonymes*) is largely contained in the French Commercial Code (*Code de Commerce* 2000, as amended, in particular

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

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

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

arts. L. 224-1 through 248-1).[8] Some questions concerning interpretation of the Commercial Code are also addressed in a governmental decree (*Décret* no. 67-236 *sur les sociétés commerciales*, as amended).

French law allows joint stock companies to choose either a one-tier or a two-tier board structure. Overall, about 97% of joint stock companies employ a one-tier board, and only 3% employ a two-tier form. However, the two-tier board is more popular among very large companies. Among the 40 major companies included in the CAC 40 stock index, 80% choose a one-tier board and 20% choose a two tier board.[9]

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

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

- The supervisory board appoints and exercises permanent monitoring of the executive board's management of the company.
- The supervisory board must approve the sale of real property, the sale of shares, the obtaining of loans, guarantees, and similar financial undertakings from companies other than banks or other financial institutions.

[8] An English version of the *Code de Commerce*, although not the most recent version, can be found at http://195.83.177.9/code/liste.phtml?lang=uk&c=32.

[9] Michel Storck, *Corporate Governance a la Francaise – Current Trends*, 1 EUR. COMPANY & FIN. L. REV. 36, 41 n.14 (2004).

- The supervisory board carries out the verifications and inspections which it considers appropriate at any time and may request whatever documents it considers appropriate for that task.
- The executive board submits a report to the supervisory board at least once each quarter.
- The executive board submits the company's annual financial and other reports to the supervisory board. The supervisory board presents its observations on the executive board's report and the financial accounts at the annual general shareholder meeting.

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

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

The principal decisions adopted by a general shareholder meeting are:

- amending the charter (Code de Commerce art. L. 225-96);
- mergers and divisions (Code de Commerce art. L. 236-9);
- changes in share capital (Code de Commerce arts. L. 225-129, 225-204);
- sale of the company's whole assets (Code de Commerce art. L. 237-8(no.4));

- approving annual accounts and distribution of profits (Code de Commerce arts. L. 232-11, 232-12);
- electing directors (Code de Commerce arts. L. 225-18, 225-75); and
- approving directors' substantial self-dealing transactions (Code de Commerce arts. L. 225-38 through 40).

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

France has adopted a voluntary Corporate Governance Code for public companies.[10]

Germany

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

The AktG requires firms to have a two-tier board structure, with a supervisory board and a management board. The supervisory board is composed entirely of non-executives, and is elected by shareholders. The powers of the supervisory board include the right to appoint the members of the management board (AktG § 84), to supervise management (AktG § 111 I), and to represent the company in dealings with members of the management board.[11]

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

[11] *See* KARSTEN SCHMIDT, GESELLSCHAFTSRECHT 820 (4th ed. 2002). Additional powers of the supervisory board include:

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

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

The management board's principal duty is to manage the company (AktG §76 I) and to represent the company in dealings with third parties (AktG § 78 I) and with the members of the supervisory board. Decisions that do not require approval by the supervisory board or by shareholders (including amendments to the charter, mergers, and the issuance of shares) can be adopted by the management board

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

on its own. However, as a practical matter, the management board will often inform the supervisory board and obtain its consent for major proposed decisions, even when this is not formally required.

Although the two boards have different powers, their formal duty of care owed to the company, for actions within their competence, is the same.[12] The duty of good faith, derived from court decisions, is also presumably the same for both boards. Therefore, our discussion of directors' duties will generally not distinguish between the two boards.

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

Commentators have speculated that codetermination is one reason why the German supervisory board has limited powers, compared to the unitary boards of directors in other countries. The logic is that the shareholders do not want to share power or information with labor representatives.[13] The expansion of codetermination in 1976 induced many companies to reduce the powers of the supervisory board specified in the charter.[14] However, other authors have suggested that codetermination may improve the flow of

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

[13] Mark J. Roe, *German Codetermination and German Securities Markets,* 1998 COLUM. BUS. L. REV. 167 (1998); Jean J. Du Plessis & Otto Sandrock, *The Rise and Fall of Supervisory Codetermination in Germany,* 16 INT'L COMPANY & COM. L. REV. 67, 74-75 (2005).

[14] Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities, in* EMPLOYEES AND CORPORATE GOVERNANCE 163, 183 (Margaret M. Blair & Mark J. Roe eds., 1999).

information to the supervisory board.[15] The empirical evidence on the effects of codetermination is inconclusive. One study suggested that codetermined firms trade at a discount in stock markets,[16] but others have found that codetermination is associated with increased productivity or improved governance.[17]

The principal decisions adopted by a general shareholder meeting are (AktG § 119 I):[18]

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

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[15] Gérard Hertig, *Codetermination as a (Partial) Substitute for Mandatory Disclosure,* 7 EUR. BUS. ORG. L. REV. 123 (2006).

[16] Gary Gorton & Frank A. Schmid, *Capital, Labor and the Firm: A Study of German Codetermination,* 2 J. EUR. ECON. ASS'N 863 (2004).

[17] Felix FitzRoy & Kornelius Kraft, *Co-determination, Efficiency and Productivity,* 43 BRIT. J. INDUS. REL. 233 (2005); Larry Fauver & Michael E. Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence from German Boards,* 82 J. FIN. ECON. 673 (2006).

[18] On the powers of shareholders in European companies, compared to American companies, see Mathias Siems, *Shareholder Protection Across Countries - Is the EU on the Right Track?,* 4/3 J. INST. COMP. 39 (2006), *available at* http://www.cesifo-group.de/DocCIDL/dicereport306-rr1.pdf.

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

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

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

Italy

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

Similar to France, Italian companies can choose between a two-tier and a one-tier board structure. Italy further complicates matters by providing for two types of one-tier boards.[19]

Korea

Korea is a civil law country. It has been influenced especially by Japan and Germany. Korean corporate law is part of the Korean Commercial Code (KCC). The KCC has also been influenced by statutes, cases, and scholarly works from Continental Europe and the United States.[20]

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[19] This is the result of a recent reform. *See* Marco Ventoruzzo, *Experiments in Comparative Corporate Law: The Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absence of Effective Regulatory Competition*, 40 TEX. INT'L L.J. 113 (2004).

[20] An English translation of the Companies portion of the KCC can be obtained at http://www.moleg.go.kr/english (follow "Economic Laws"

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

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

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

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

In 1999, the Korean Committee on Corporate Governance adopted a Code of Best Practice for Corporate Governance, which was revised in 2003. The code is similar in concept to the Russian Corporate Governance Code, in that it is solely

hyperlink to get a list of laws; then go to page five of the list and follow "Commercial Act" hyperlink).

an informal guideline for the corporate governance of public companies. In contrast to the United Kingdom, companies have no obligation to either comply with the code or explain to shareholders why they have not done so. However, the Korean government is planning to add a "comply with the Code or explain why not" obligation to either the KSEA or the listing rules of the Korea Stock Exchange.

Latvia

Latvia is a civil law country. Its legal system is strongly influenced by Germany. The Latvian Commercial Code[21] contains separate chapters which govern joint stock companies and limited liability companies, although there are also some common provisions that govern both types of companies. The chapter on joint stock companies follows the German model of a two-tier board structure.

United Kingdom

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

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

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

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

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

The Companies Act does not directly confer managerial powers on a company's directors. Instead, the directors' authority is specified in the company's charter.[22] In practice, company charters give wide and usually unlimited management authority to the board of directors. A provision granting this unlimited authority is part of the standard default charter, which is appended to the Companies Act and applies unless a specific company charter provides otherwise (Companies Act 1985, § 8). This standard charter is known

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

as Table A.[23] A recent survey finds that all 100 of the public companies included in the FTSE 100 stock index vest complete management authority in the company's board.

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

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

Corporate legislation in the United Kingdom does not form a comprehensive code of corporate law. The legislation is supplemented by judge-made law, usually called "common law." This common law can potentially differ between (a) England and Wales; (b) Scotland; and (c) Northern Ireland. However, decisions in one jurisdiction are persuasive in the others, and the differences in the area of corporate law are usually not large. Also, most important decisions on company law are rendered in the courts of England and Wales, especially the courts in London, which is the U.K.'s principal financial centre. We therefore discuss here only the common law of England and Wales.[24]

When procedural rules are relevant, we discuss only the procedural rules applicable in England and Wales. For

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

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

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

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

Plcs that have carried out a public offering and are listed for trading on the main market of the London Stock Exchange are known as listed companies and must comply with Listing Rules and Disclosure Rules formulated and enforced by the Financial Services Authority. These listing and disclosure rules are an important additional source of regulation, even though they are technically not "law."[25]

The United Kingdom has created, over a period of twenty years, several codes of corporate governance, which have now been collected into a single "Combined Code of Corporate Governance."[26] The provisions of the Combined Code are voluntary, but in most cases, public companies that do not comply must so state annually and explain why they have chosen not to comply. This report was written during a period in which the 2003 version of the Combined Code was being gradually replaced by the 2006 version. This change occurs over a period of time because the applicability of the

[25] The Listing Rules are available at http://fsahandbook.info/FSA/html/handbook/LR. The Disclosure Rules are available at http://fsahandbook.info/FSA/html/handbook/DTR.

[26] FIN. REPORTING COUNCIL, COMBINED CODE OF CORPORATE GOVERNANCE (June 2006), *available at* http://www.frc.org.uk/corporate/combinedcode.cfm.

new version of the Combined Code depends on when a company's accounting year begins. The differences between the 2003 and 2006 versions of the Combined Code do not affect this report.

United States

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

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

United States "securities law" is federal, and governs important aspects of what might be considered to be companies law. Federal securities law is binding on all publicly traded companies, regardless of which state they are incorporated in. An example of the manner in which federal securities law can address topics that would otherwise be covered in state corporation law is the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act regulates, among other matters, the composition of the board of directors, as between inside and outside directors, and the composition and role of the audit committee of the board of directors.[27] We discuss United States securities law to the extent that it includes rules that affect the liability of directors for breach of duty to the company. We do not discuss securities law in

[27] For a critical assessment of the Sarbanes-Oxley Act, see Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

general. Thus, we do not discuss the obligations of directors under securities law to provide disclosure to investors of material information concerning the company.

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

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

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

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

General Assessment of Laws in Comparison Countries

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

system, in which the supervisory board has more limited powers than a Russian board of directors.

With regard to derivative suits by shareholders to enforce the duties of directors, procedural obstacles to bringing these suits, including "loser pays" attorney fee rules, have made these suits uncommon in a number of countries, including Canada, Germany, and the U.K. The United States has shareholder suits in substantial numbers, but under complex rules that Russia would be advised to avoid rather than copy. In other countries, there has been a trend over time toward reforms to encourage derivative suits, including recent reforms in Germany (2005) and the U.K. (in the Companies Act 2006) and earlier reforms in Japan and Korea.[28]

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

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

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

instructions from superiors in the government and to act only in the interests of the company.

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

Subchapter 1.2. Concept of reasonableness and good faith

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

Russian context

The terms "good faith" and "reasonableness" are frequently encountered in Russian civil law, for example in the Civil Code provisions on exercise of civil rights and on the concept of a good-faith purchaser,[29] and the general principle that all participants in civil commerce are obligated to act reasonably and in good faith.[30] Civil Code art. 10(3)

[29] For further information, see Evgeny Bogdanov, *The Category of Good Faith in Civil Law*, 9 RUSS. JUST. 12 (1999) (Евгений Богданов, *Категория «добросовестности» в гражданском праве*, РОССИЙСКАЯ ЮСТИЦИЯ); S.A. Ivanova, *Problems in the Realization of the Principle of Social Justice, Reasonableness and Good Faith in the Law of Obligation*, 4 LAW & ECON. 29 (2005) (С.А. Иванова, *Некоторые проблемы реализации принципа социальной справедливости, разумности и добросовестности в обязательственном праве*, ЗАКОНОДАТЕЛЬСТВО И ЭКОНОМИКА); 1 M.I. BRAGINSKIY & V.V. VITRYANSKIY, CONTRACT LAW (Statut Press, 2000) (М.И. БРАГИНСКИЙ & В.В. ВИТРЯНСКИЙ, ДОГОВОРНОЕ ПРАВО, Статут).

[30] For an opposing view, see V.I. YEMELYANOV, REASONABLENESS, GOOD FAITH AND NON-ABUSE OF CIVIL RIGHTS (Lex-Kniga Press, 2002) (В.И.

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

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

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

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

Russian legislation does not define the concepts of good faith and reasonableness; instead, the so-called "golden rule of interpretation" is used, whereby the words and expressions used in legislation are to be accorded their standard, everyday meanings.[31] In Russian, the term "good faith" is considered to be synonymous with honesty and truthfulness. Only an individual who honestly fulfills his or her duties can be said to act in good faith. The word "reasonable" is taken to mean "prudent," or "based on reason." It would thus seem that, in light of the specific nature of the position held by a member of a company's governing organ, his conduct must be compared not to the conduct of any ordinary individual but, instead, to the conduct of a person occupying a similar position.

ЕМЕЛЬЯНОВ, РАЗУМНОСТЬ, ДОБРОСОВЕСТНОСТЬ, НЕЗЛОУПОТРЕБЛЕНИЕ ГРАЖДАНСКИМИ ПРАВАМИ, Лекс-Книга).

[31] *See* Ivanova (2005), *supra* note 29; BRAGINSKIY & VITRYANSKIY (2000), *supra* note 29.

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

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

There is no significant theoretical research on the relationship between the concepts of "good faith" and "fault" in Russian civil law. During the Soviet period, civil law relied on the criminal law concept of fault, albeit without justification. Some authors point out that the concept of fault is already included within the concept of "bad faith."[32] However, even if action in bad faith necessarily involves fault, fault can also exist without bad faith.

One source suggests that the fault of a person in modern civil law is determined "using an abstract model of expected conduct in this or that situation for *participants in property transactions acting reasonably and with good faith.*"[33] But if this is correct, it is not clear what the general civil law requirement of fault adds to the conditions for civil liability, once a person is found to have acted unreasonably or in bad faith. Put differently, it is not clear under what circumstances a person can act unreasonably or in bad faith, and yet be said not to have the degree of fault required for civil liability. Conversely, if a person acts with civil fault, it is not clear under what circumstances the person could still be found to have acted reasonably and in good faith.

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[32] *See* YEMELYANOV (2002), *supra* note 30.

[33] *See* Ivanova (2005), *supra* note 29.

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

The use in the law of moral norms, such as good faith and reasonableness, is complicated by the abstract nature of these concepts. Neither legislation nor judicial decisions provide a more precise definition. Indeed, it has been suggested that "the legal definition of any kind of parameters of the concept of 'good faith' . . . is theoretically impossible."[34] This same view applies to the category of "reasonableness."[35] Russian legislation does not include the concept of fiduciary relations, to which one might look for guidance in determining when actions by members of a governing organ are considered to be in good faith.

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

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

[34] V.V. Vitryanskiy, *The Civil Code and the Court*, 7 BULL. SUP. ARBITRAZH CT. RUSS. FED'N 132 (1997) (В.В. Витрянский, *Гражданский кодекс и суд*, ВЕСТНИК ВЫСШЕГО АРБИТРАЖНОГО СУДА РОССИЙСКОЙ ФЕДЕРАЦИИ).

[35] *See, e.g.*, Ivanova (2005), *supra* note 29 ("There is no possibility of uniformly establishing the scope of the concept [of reasonableness] without resorting to other similar evaluative categories.").

indicate that they *acted exclusively in the interests of the company*.

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

- failure to attend board of directors meetings without good cause;
- failure to implement decisions of the board of directors or shareholder meetings;
- failure to abide by company rules, business principles, and ethical norms; and
- participating in a transaction involving a conflict between the person's individual interests and the company's interests, without obtaining the approval required by the JSC Law.[36]

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

- entering into a transaction without considering the company's interests,[37] and
- exhibiting lack of interest in fulfilling one's duties.[38]

Canada

In Canada, corporate statutory law contains two principal fiduciary duties owed by directors and officers to their

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

[37] 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).

[38] 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).

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

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

With regard to the first duty, directors, when making decisions on behalf of the company, must "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances" (CBCA § 122(1)(b)). The reference to "reasonably prudent person" is understood to impose on directors a duty to possess a normal degree of business skill and experience. A poorly qualified director cannot escape liability simply because he did his best.[39]

Courts and commentators are divided on whether "comparable circumstances" requires judges to take into account the skills of a particular director, or instead refers to

[39] MARKUS KOEHNEN, OPPRESSION AND RELATED REMEDIES 220, 223 (2004).

the factual circumstances in which the decision was made. For example, should the level of diligence be relaxed if a quick decision was required, compared to a situation in which the directors had time for investigation and careful deliberation?[40]

Canadian corporate law also requires directors to act honestly and in good faith with a view to the best interests of the corporation (CBCA § 122(1)(a), OBCA § 134(1)(a)). "Good faith" is not defined in either the CBCA or the OBCA. Directors who exercise their powers to advance their own interests obviously breach the duty of honesty and good faith. A more difficult situation is where a decision plausibly was taken to advance the corporation's interests, but also provides a personal benefit to the directors. The directors will claim they have acted in good faith. In deciding whether the directors have breached their duty, the court will seek to ascertain which motive was dominant—a motive to benefit the corporation, or a motive to benefit themselves. The courts will consider whether there were reasonable grounds for the directors' claim that they acted primarily in the interests of the corporation.[41]

France

For the most part, the Code de Commerce does not phrase the duties of directors in an affirmative fashion. Commentators and case law state that directors have a fiduciary duty (*bonne foi*, or good faith) to the company.[42] This duty can be violated through disloyalty (*déloyauté*) if a director acts to further his personal interests, rather than the company's interest (*intérêt sociale*).[43]

French corporate law does not specify how directors should behave. It focuses instead on various breaches of the

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[40] *Id.* at 221.

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

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

[43] *See* TERRE ET AL., LE DIRIGEANT DE SOCIETE: RISQUES & RESPONSABILITES ¶ 061-11 (2002).

law. It does not use the terms reasonableness or good faith, as such.

One-Tier Board

For companies with a one-tier board, there is a board of directors (*conseil d'administration*) and its chairman (*president*). The board appoints the Chief Executive Officer (CEO) (*directeur général*).[44] It is possible but not necessary for the CEO to be a member of the board. It is also possible for the CEO to also be the chairman of the board. In this case, the CEO is called the (*président directeur general,* or *PDG*). The board can also appoint "assistant general managers" (*directeurs généraux délégués*). These managers, like the CEO, may or may or not be members of the board.

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

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

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

[44] Note the different use of the words "*director*" in British and American law and "*directeur*" in French law.

oneself (*fautes de gestion*) and in supervising the actions of others (*fautes de surveillance*).[45]

Article L. 225-251 of the Code de Commerce does not apply to assistant general managers, unless they are members of the board. Their liability is therefore based on general principles of civil law established in the French Civil Code.[46]

Two-tier Board

If a French company chooses to adopt a two-tier board structure, it will have a supervisory board and a management board (*directoire*). The company can also choose to have a sole managing director instead of a multi-member management board. The members of the management board face liability under art. L. 225-251, which is quoted above.[47]

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

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

Germany

German corporate law contains two principal duties of directors toward their companies: an explicit duty of

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[45] FRANCIS LEFEBVRE, MEMENTO SOCIETES COMMERCIALES ¶ 8483 (2006); DALLOZ, CODE DE SOCIETES 698 (21st ed. 2005). With regard to liability for failure to act, see CA Paris, Sept. 19, 1995, Dr. soc. janv. 1996, no 19; TERRE ET AL. (2006), *supra* note 43, at ¶ 061-12.

[46] LEFEBVRE (2006), *supra* note 45, at ¶ 8824.

[47] C. COM. art. L. 225-256 (Fr.).

diligence and an implicit duty of loyalty. The duty of loyalty is not directly stated in the AktG, and instead has been developed through judicial decisions. The AktG does not contain a requirement of reasonableness, as such, or a requirement of good faith, as such.

Duty of Care and Diligence

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

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

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

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

The elements of this statutory "business judgment rule" defence have not been defined in more detail by the law, and

there are as yet no relevant court decisions interpreting the new statutory provision.

Under AktG § 93, directors are required to act for the benefit of the company (*Gesellschaftswohl*). The meaning of this term is uncertain, but it should probably be interpreted to be identical with the term *Unternehmensinteresse* (interest of the business), which had been previously used in the AktG (though not since 1965). The concept of benefit of the company is a broad concept, which is not limited to the interests of shareholders only, but also includes the interests of employees and the general public.[48]

Duty of Loyalty

Directors may also be liable, both under the AktG and under criminal law, if they violate their duty of loyalty to the firm.[49] This duty can be considered to be similar to the duty of good faith under Russian law. It is referred to in judicial decisions, but is not directly based on a specific provision of the AktG. Commentators have argued that a statutory basis can be found under AktG § 76 (which refers to the board's responsibility for management of the company), § 84 (which discusses appointment of the management board, with the idea being that fiduciary duty may follow from this appointment), or § 93 (which we have quoted above, and can be broadly understood to be violated if the interests of the company are harmed). The duty of loyalty can be understood to derive the general civil law duty of "*Treu und Glauben*" (good faith) for parties to a contract.[50] The idea is that the duty of loyalty follows from appointment as a director, and from the fact that the directors have a duty to act in the

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

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

[50] BGB [German Civil Code] § 242.

interests of the company, and are responsible for managing someone else's property.[51]

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

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

While the duty of loyalty is discussed by commentators, the scope of the duty remains unclear. Case law applying it to joint stock companies in the Supreme Federal Court is rare, which is likely related to the absence of an effective mechanism for shareholders to bring a derivative suit (2005 amendments to the AktG liberalize the derivative suit procedure). The recent decision in the Mannesmann criminal case (discussed later in this Report) is probably the clearest statement so far.[52] The other cases involving the duty of loyalty in joint stock companies are old. Some do not explicitly use the term "duty of loyalty," but instead simply state that a specific transaction by a director was not permitted.[53]

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[51] *See* 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 76 (Wolfgang Hefermehl & Gerald Spindler), ¶ 14 (Bruno Kropff & Johannes Semler eds., 2d ed. 2004); HÜFFER (2006), *supra* note 48, at § 84, ¶ 9.

[52] BGH 21.12.2005 - Az: 3 StR 470/04, NJW 2006, 522.

[53] *See* RGZ 96, 53 (1919) (decision of the German Imperial Court on the purchase of ships from a company owned by a director where the company paid an excessive commission); BGHZ 20, 239 = NJW 1956, 906 (hidden payment of remuneration, violating the AktG requirement for

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

There are also cases concerning the duty of loyalty in limited liability companies. Most of these seem to concern the duty not to compete with the company, which is explicitly stated in the joint stock company law but is not explicitly stated in the limited liability company law.[54] There is also case law prohibiting management directors from making personal use of business opportunities that were also available to the company.[55]

Application to Other Persons

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

Korea

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

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

While, in theory, simple negligence can produce liability, in practice, the courts are reluctant to second-guess business decisions. Without directly saying so, the Korean courts may

disclosure to the supervisory board). Other early cases mention the duty of loyalty but are centrally concerned with other issues. *See, e.g.*, BGHZ 10, 187 = NJW 1953, 1465; BGHZ 13, 188 = NJW 1954, 998; BGHZ 49, 30.

[54] *See, e.g.*, BGH NJW 1986, 586; BGH DStR 1997, 1053.

[55] BGH GmbHR 1989, 365.

follow an approach that is similar to the business judgment rule applied in the United States.[56]

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

United Kingdom

The fiduciary duties of U.K. directors were developed through judicial decisions, and, until the adoption of the Companies Act 2006, were not stated in the companies statute. We first discuss existing case law, and then the new codification. The principal duties owed by directors to a company are the duties of care and loyalty. The terms reasonableness and good faith are not expressly included in customary statements of these duties, as such. Nevertheless, the duty of care includes a duty of reasonable diligence, and the duty of loyalty includes an obligation to act in good faith.

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

> A person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. That duty will vary according to the size and business of the particular company and the experience or skills that the director held himself or herself out to have in support of appointment to the office.[57]

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[56] *See* Hwa-Jin Kim, *Directors Duties and Liabilities in Corporate Control and Restructuring Transactions: Recent Developments in Korea*, 2006 OXFORD U. COMP. L.F. 2 (2006), *available at* http://ouclf.iuscomp.org/articles/kim.shtml.

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

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

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

> [39]Mr Milligan QC referred me to another general statement about the duties of directors which I find helpful as it both expresses what may be expected of a "reasonably diligent" director and acknowledges the obvious qualification that what the test requires must depend on the particular circumstances before the court. The reference is in the judgment of Morritt LJ in *Re Barings Plc (No 5)* [2000] 1 BCLC 523 at page 535 where the Court of Appeal approved the summary given by Jonathan Parker J at first instance in these terms:
>
> > (i)Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.
> >
> > (ii)Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.
> >
> > (iii)No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director's role in the management of the company.[58]

The concept of "good faith" is not defined in English law. In general, it is assumed to exist, and it is up to the plaintiff to instead prove bad faith. Bad faith involves conscious intention or motive to deviate from a director's duty to act in

[58] [2003] EWHC 2263 (Comm.), [2004] 1 B.C.L.C. 180, at [35]-[39] (opinion of Langley, J.).

the interests of the company.[59] The existence of a personal interest in a transaction is evidence that a director may be acting in bad faith, but is not, without more, proof of bad faith.[60] The overlap between the requirement of good faith and the requirement of loyalty is a complex one.[61]

Codification of Duties of Care and Loyalty

The Companies Act 2006 will, for the first time, codify the fiduciary duties of directors.[62] The new provisions are intended to codify rather than change the existing common law duties of care and loyalty, with two exceptions. The first change is that a self-dealing transaction will need to be disclosed to and approved only by the board, not by shareholders. The company will not need to disclose to shareholders the reason for the director's conflict, but will still have to disclose the *transaction itself*.[63] The second change permits *board* (rather than shareholder) authorisation of most conflicts of interest arising from a director's dealings with third parties (for example, personal exploitation of business opportunities that might also have been available to the company).[64] The Companies Act 2006 also includes a new statutory duty of disclosure.[65]

United States

The two principal fiduciary duties of directors of corporations in the United States are the duty of care and the duty of loyalty. While some recent Delaware cases speak of a duty of good faith, it is unclear to what extent this duty

[59] *See, e.g.*, *Re* Smith & Fawcett Ltd., [1942] Ch. 304; Regentcrest plc (in liquidation) v. Cohen, [2001] 2 B.C.L.C. 80, 105.

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

[61] Matthew Conaglen, *The Nature and Function of Fiduciary Loyalty*, 121 LAW Q. REV. 452, 472-75 (2005).

[62] *See* Companies Act 2006, §§ 170-181 (U.K.) (codifying existing duties).

[63] *Id.*, §§ 177, 182.

[64] *Id.*, § 175(5-6).

[65] *Id.*, §§ 182-187.

differs from the traditional duty of loyalty, which already imposes a requirement of good faith.[66]

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

> Each member of the board of directors . . . shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.[67]

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

> The members of the board of directors . . . shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.[68]

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

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

- a director "intentionally acts with a purpose other than that of advancing the best interests of the corporation,"

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

[67] MODEL BUS. CORP. ACT § 8.30(a) (2005).

[68] *Id.*, § 8.30(b).

- a director "acts with intent to violate applicable positive law," or
- a director "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[69]

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

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

Instead, in the United States, the courts apply a defense known as the business judgment rule. Under this rule, they usually assess only whether the directors were reasonably informed. If the directors were reasonably informed, the courts do not assess whether the directors' decisions were reasonable as a substantive matter. Put differently, the duty of care is mostly an aspirational statement about how directors should try to act. It is not a basis for liability if the directors fall short of this standard.[70]

Summary and recommendations

The table below summarizes the core duties owed by directors in the countries we considered, and compares these duties to the duties of reasonableness and good faith

[69] *In re* the Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006).

[70] We discuss the business judgment rule *infra* in Subch. 1.3.

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

Overview of Duties of Directors under Company Law

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

* France and Germany do not have a duty of disclosure as such, under company law. However, European Union Directive 2006/46/EC requires member states, by 2008, to adopt rules providing for disclosure by public companies of conflict of interest transactions.[71]

[71] We discuss these rules *infra* in Subch. 1.5.

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

Liability based on fault

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

Regulation of potential conflict of interest transactions

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

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

Duty of reasonableness

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

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

Business judgment rule

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

We recommend that Russia adopt a form of the business judgment rule, in which if directors are reasonably informed, and adopt a decision that does not personally benefit themselves, their fellow directors, or the company's controlling shareholders, there should be a strong presumption that they have acted reasonably. As long as

there is no evidence of a conflict of interest, the plaintiffs should be required to show that no rational director could have adopted the decision, in order for the court to find that the directors are liable for failure to act reasonably.

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

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

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

Duty of good faith

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

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

The requirement to disclose and obtain approval of a conflict of interest transaction applies to any transaction,

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

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

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

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

We discuss the legal presumptions that should apply to different aspects of the duty of good faith in Subch. 1.3. The

proposed definition of the concept of good faith draws on the concept of a conflict of interest, which is discussed in Subch. 1.4.

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

Duty of disclosure

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

- disclosure to the company of any direct or indirect interest that a director or manager, and his affiliated persons, has which may conflict with the interests of the company, including a significant ownership interest in another company;
- disclosure to the company of any transactions or proposed transactions, directly or indirectly involving the company or any of its subsidiaries or dependent companies, in which the director or manager, or his affiliated persons, has a conflict of interests, in advance of completion of the transaction;
- disclosure to the shareholders of any significant completed transactions, directly or indirectly involving the company or any of its subsidiaries or dependent companies, in which the director or manager, or his

affiliated persons, has a conflict of interests, including the nature of the conflict; and

- disclosure to the shareholders, in connection with a matter brought for decision to a general shareholder meeting, of information known to the directors that a reasonable shareholder would be likely to consider to be important in deciding how to vote, including information about any direct or indirect conflicts of interests that the directors, managers, or controlling shareholder have with respect to the decision.

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

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

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

For a Russian company which has a collegial executive organ, the current rules are fine. However, there is a risk that companies may seek to reduce the liability risk of senior managers by choosing to have an individual executive organ rather than a collegial executive organ. For a company with an individual executive organ, only this person can be liable for breach of duty to the company. If this risk of evasion becomes a practical problem in Russia, it could be addressed by requiring that a public company have a collegial executive

organ. We do not make a recommendation on this question, because we are not persuaded that this issue is a serious one at the present time. In particular, many public companies already have a collegial executive organ.

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

Extension of duty of good faith to controlling shareholders

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

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

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

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

Russian context

As discussed in Subch. 1.1, it is a general principle of civil law that all participants in civil transactions are obligated to act reasonably and in good faith. According to Civil Code art. 10(3), "participants in civil relations are presumed to exhibit reasonable conduct and good faith" in cases where their rights depend on whether their actions reflect reasonableness and good faith. This presumption can be rebutted, but the plaintiff has the burden of rebutting it. This presumption is consistent with general rules of civil procedure. Civil Code art. 53 and JSC Law art. 71 establish the duty of governing entities to act reasonably and in good faith. When bringing a suit against these persons, plaintiffs must follow a general procedural provision whereby a plaintiff must prove any statements he makes. Thus, plaintiffs must show that the defendants violated this obligation—in other words, that they acted without reasonableness or without good faith.

Canada

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

director had breached the duty of care simply because a business decision went badly wrong.[72]

The Supreme Court of Canada appeared to depart radically from past practice when it ruled in 2004 that Canadian courts should apply a "business judgment rule" when assessing whether there has been a breach of duty by directors.[73] The Canadian version of the business judgment rule differs, however, from its U.S. counterpart. The Canadian business judgment rule does not include an explicit presumption of good faith, as such. Instead, it applies only to transactions not involving a conflict of interest, for which the issue to be decided is typically whether the directors have met their duty of care, diligence, and skill, rather than whether they have met their duty of honesty and good faith.

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

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

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

[72] Can. Corp. L. Rep. (CCH) ¶ 6050.

[73] People's Dep't Stores v. Wise, [2004] 3 S.C.R. 461, 491-92 (Can.).

cases of this sort the courts will generally presume the directors acted in good faith, and it will be up to the plaintiff to produce evidence that the directors did not act in good faith.[74]

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

France

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

Mere business decisions not involving disloyalty will only result in liability if they are manifestly absurd,[75] for example, providing a loan under circumstances where it was certain that it would not be repaid,[76] or in the case of an insistence to pursue a sale at a loss.[77] More generally, there

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[74] *See* KOEHNEN (2004), *supra* note 39, at 229.

[75] *See* TERRÉ ET AL. (2002), *supra* note 43, at ¶ 061-11 (discussing "strategic errors"). *Cf.* GUYON (2001), *supra* note 42, at ¶ 459 (incurring regular business risks will not result in liability; liability can be found only if the decision would be considered unreasonable at the time when it was made).

[76] C.A. Paris, Feb. 4, 1994, Rev. soc. 1994, at 136.

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

are said to be limits because of an implicit business judgement rule (*droit à l'erreur*), reluctance to second guess corporate decision making, and discretion in ascertaining negligence.[78]

Germany and Austria

Duty of diligence

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

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

The provision was meant to codify existing law.[79] It follows the opinion of the Federal Supreme Court (*BGH*) in the *ARAG/Garmenbeck* case.[80] Uwe Hüffer suggests, in his treatise on the *Aktiengesetz*, that the provision does not merely shift the burden of proof to the plaintiff if its conditions are met, but creates a completely safe harbor.[81] There have not yet been any court decisions interpreting the scope of this new provision.

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

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

[79] UMAG, Sept. 22, 2005, BGBl I at 2802 (F.R.G.).

[80] BGHZ 135, 244; *see also* Erich Schanze, *Directors' Duties in Germany*, 3 COMPANY & FIN. INSOLVENCY L. REV. 286, 291 (1999) (discussing this case).

[81] HÜFFER (2006), *supra* note 48, at § 93, ¶ 4c.

with the "business judgment rule" introduced in AktG §93 I 2.

Uwe Hüffer suggests that the two provisions can be reconciled as follows. The plaintiff has the burden of proof with respect to the director's conduct, damages incurred, and the causal link between the director's conduct and the damages. The defendant then needs to prove the elements of the business judgment rule, but is relieved from any claims if he succeeds in doing so.[82] That is, the director must show that he reasonably *believed* he was acting in the interests of the company on the basis of adequate information. If the director shows that this belief was reasonable, it will not matter whether the belief was objectively correct.

Duty of diligence in Austria

Austrian law corresponds to German law before 2005. Thus, there is no explicit statutory statement of a business judgement rule and, once the plaintiff has shown the director's conduct, harm to the company, and causation, the director has the burden of proving that he met the statutory standard of diligence. However, it is still recognized that wide discretion should be accorded to managers when they make business decisions without a conflict of interest.[83]

Duty of good faith

As discussed in Subch. 1.2, the German and Austrian AktGs do not contain an express obligation of good faith. The courts have established such an obligation through decisions. These decisions do not address the question of presumptions or burden of proof for breach of the duty of good faith. Under general principles of civil procedure, one may assume in both countries that the plaintiff has the burden of showing lack of good faith.

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[82] *Id.* ¶ 16, 16a.

[83] *See, e.g.*, OGH 1 Ob 144/01k; 8 Ob 262/02s; *see also* 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 84 (Susanne Kalss), ¶ 200 (Bruno Kropff & Johannes Semler eds., 2d ed. 2004).

Korea

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

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

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

United Kingdom

In England, there is a general assumption that persons have acted in good faith. Anyone who alleges bad faith must state and prove this claim and do both clearly. This presumption is not limited to company law. It can be seen most easily from the English rules of civil procedure, which address the question of pleading and proving conscious bad faith (and cognate concepts such as fraud).[84] The effect of

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

these rules is that bad faith must be specifically pleaded, and at trial the claim of bad faith must be supported by evidence: it is not to be assumed.

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

United States

Business Judgment Rule

As a general rule, American courts do not hold directors liable for business decisions, made without a conflict of interest, unless those decisions are completely irrational. This doctrine of judicial non-interference is known as the *business judgment rule*. The business judgment rule involves a presumption that the directors have acted on an informed basis, in good faith, and in the interests of the corporation. The plaintiff must rebut one or more of these presumptions.

In cases involving a conflict of interest, it will often be straightforward to overcome the presumption of good faith. If a conflict of interest cannot be shown, then it will be rare for the plaintiff to be able to rebut the presumption of good faith. If the plaintiff cannot rebut the presumption of good faith, the plaintiff is left with the difficult challenge of showing that the directors have not acted on an informed basis, and overcoming the presumption that they have acted on an informed basis. If the plaintiff cannot rebut the presumption that the directors have acted on an informed basis, the plaintiff will lose the case. The courts will not review the merits of the decision they made. The business judgment rule, *not* the ordinary negligence standard, sets the standard by which breach of the duty of care is measured.[85]

[85] The classic explanation for the business judgment rule as a doctrine of "judicial abstention" is offered by Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics and Tender Offers*, 3 STAN. L. REV. 819, 823 (1981).

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

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

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

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

not get better decisions on average, just more cautious decisions.

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

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

Summary and recommendations

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

the concept that a director must act in the interests of the company, when these conflict with his personal interests.

Overview of Presumptions for Duties of Directors

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

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

presumption of good faith to transactions involving a conflict of interest.

Presumption of reasonableness and good faith, if no conflict exists

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

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

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

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

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

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

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

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

should be considered to satisfy both the duty of reasonableness and the duty of good faith.

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

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

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

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

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

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

Subchapter 1.4. Concept of self-interest

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

General comments

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

Transactions in which a director, senior manager, or major shareholder has a direct or indirect financial or other interest are given several names. They can be called "related party transactions," "self-interested transactions," "self-dealing transactions," or "conflict-of-interest transactions." We use the term "conflict-of-interest transactions."[86]

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

[86] For a general overview of the approaches used in different countries to control self-dealing, see Luca Enriques, *The Law on Company Director Self-Dealing: A Comparative Analysis*, 2 INT'L & COMP. CORP. L.J. 297 (2000).

Russian context

Defining a Transaction Involving a Self-Interest

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

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

Some scholars are of the opinion that shareholders should not be included in this list because the purpose of the conflict-of-interest rules is to prevent abuse of power by members of a company's management organs, and shareholders are not members of these organs.[87] The inclusion of the concept of an affiliate significantly broadens the scope of interested persons, and can complicate the determination of whether a transaction involves a self-

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

interest.[88] Persons who may potentially have the right to give a company binding instructions are:

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

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

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

Under the JSC Law, transactions involving a self-interest should be approved following a defined procedure. Failure to

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

comply with the procedure will invalidate the transactions, and, if the company incurs losses as a result of the transaction, the self-interested persons can be held liable. We will consider each step separately.

The Procedure for the Approval of a Self-Interested Transaction

The procedure for approval of a self-interested transaction depends on the number of shareholders of the company and the amount of assets involved in the transaction. If the company has 1000 or fewer shareholders, the decision on approval of the transaction must be adopted by the board of directors by a majority of votes of directors who do not have a self-interest in the transaction. If the company has more than 1000 shareholders, the decision on approval of the transaction must be adopted by the board of directors by a majority of votes of the *independent* directors who do not have a self-interest in the transaction.[89] The JSC Law does not indicate the number of independent directors necessary to have authority to approve a self-interested transaction. Thus, a decision to approve a self-interested transaction can be adopted by even a single independent director if all other independent directors are interested persons.

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

[89] We discuss the concept of an independent director *infra* in Chapter 2.

- *Transaction Participants.* Courts have repeatedly come to the conclusion that, in cases where the "factual owner" of the assets in one transaction and the parties to another transaction are the same, the transactions are considered interrelated.[90]
- *Purpose of Entering into a Transaction.* If the transactions have a unified economic purpose, then they are deemed interrelated.[91]
- *Time of the Conclusion of the Transactions.* The conclusion of the transactions at similar (different) times is evidence of interrelatedness (lack of interrelatedness) between transactions.[92]
- *Unified Purpose for the Subject of the Transactions.* If the assets which are the subject of two or more transactions have a unified purpose (for example, their

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

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

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

use in the same or related economic activities), this is evidence of interrelatedness of the transactions.[93]

- *Types of Transactions.* The fact that transactions vary in their legal nature allows the courts to consider them not interrelated.

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

When a company incurs losses through a transaction involving individual interest, the liability of the interested person shall be determined by JSC Law 84(2).[94] There is a general Civil Code rule that liability requires the existence of fault (Civil Code art. 401). Therefore, some scholars have argued that liability for improper approval of a self-interested transaction should also require fault.[95] It is also essential to show causation between the losses and the actions of the interested person. In practice, proving such a link is extremely complicated.

The question of which persons have the right to file a claim for the recovery of losses from the interested person remains unresolved. Some scholars contend that both the shareholder and the company itself have this right, while others argue that the company alone has this right.[96]

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

[94] We discuss the concept of losses in Subch. 2.7.

[95] M.V. Telyukina, *The Approval of Transactions Involving Individual Interest*, 3 ARBITRAZH PRAC. (2005) (М.В. Телюкина *Одобрение заинтересованных сделок*, АРБИТРАЖНАЯ ПРАКТИКА).

[96] For the former view, see V.P. MOZOLIN & A.P. YUDENKOV, COMMENTARY ON THE FEDERAL LAW ON JOINT-STOCK COMPANIES (Norma Press, 2003) (В.П. МОЗОЛИН, А.П. ЮДЕНКОВ КОММЕНТАРИЙ К ФЕДЕРАЛЬНОМУ

Treating a Transaction as Invalid Due to Noncompliance with Approval Procedure

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

The law, however, leaves open several questions. First, it is unclear whether persons who became shareholders after the transaction is completed have the right to file suit. Legal precedent tends to favor of conferring the right to file suit only on persons who were shareholders when the transaction was completed.[97]

Second, the JSC Law does not specify when the statute of limitations on a suit to invalidate a self-interested transaction begins to run—when the transaction is completed, or when the shareholder or the company learned (or should have learned) that the transaction involved a self-interest? (Civil Code art. 181(2)). Legal precedent indicates that "the statute [of limitations] should begin to run at the point where the shareholder/company learned or had a

ЗАКОНУ «ОБ АКЦИОНЕРНЫХ ОБЩЕСТВАХ», Издательство Норма). For the second view, see M.V. TELYUKINA, COMMENTARY ON THE FEDERAL LAW ON JOINT-STOCK COMPANIES (Wolters Kluwer Press, 2005) (М.В. ТЕЛЮКИНА КОММЕНТАРИЙ К ФЕДЕРАЛЬНОМУ ЗАКОНУ «ОБ АКЦИОНЕРНЫХ ОБЩЕСТВАХ» (ПОСТАТЕЙНЫЙ) (Волтерс Клувер).

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

realistic chance to learn not only of the completion of the transaction itself but also of the fact that it was entered into by persons interested in its conclusion."[98]

Third, is noncompliance with the approval procedure a sufficient basis to invalidate a transaction, or must the company have incurred losses as well? Amendments have been proposed to the JSC Law to allow for invalidation only if the company has incurred losses.[99]

Transactions involving a self-interest, as defined in JSC Law arts. 81-84, are part of the more general concept of "conflict of interest."[100] In our view, many of the legislative shortcomings indicated above became possible due to the insufficient development of the general notion of "conflict of interest" in Russian law.

Canada

In Canada, there are conflict-of-interest rules specifically directed to situations where a director or officer engages, directly or indirectly, in a transaction with his or her company. There are no rules directed to the situation where a dominant shareholder, who is not a director, has done so. Under Canadian law, dominant shareholders do not owe any fiduciary duties to minority shareholders. In practice,

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

[99] *See* Outline of the Development of Corporative Legislation for 2008 prepared by the National Council on Corporate Management («Концепция развития корпоративного законодательства на 2008 год», подготовленная Национальным Советом по Корпоративному Управлению) and Draft of the Federal Law "On the Introduction of Amendments into Some Laws of the Russian Federation (in the area of corporate conflict resolution improvement)" (Draft No. 384664-4) (Законопроект «О внесении изменений в некоторые законодательные акты Российской Федерации (в части совершенствования разрешения корпоративных конфликтов)» (Проект N 384664-4)).

[100] We discuss the concept of conflict of interest further in Subch. 3.4.

however, if a dominant shareholder carries out conflict-of-interest transactions which are prejudicial to the interests of the company or the minority shareholders, minority shareholders should be able to obtain relief under the oppression remedy provided by Canadian corporate legislation.

Under the judge-developed common law, contracts where the director of a company was a party to a contract with the company were voidable at the company's option, whether or not the transaction was fair to the corporation. The CBCA and other Canadian statutes adopt a more permissive approach, and permit certain transactions between a director or officer and the corporation, provided that procedural safeguards are observed, which are intended to make it more likely that the transaction is fair to the company.[101] Under CBCA § 120, if a director or officer is a party to, or otherwise has a material interest in, a "material" contract with the corporation, the interested director or officer must give written notice to the corporation of the nature and extent of the interest or have the information entered into the minutes of a directors' meeting. When notice is given, the contract must be approved by the board of directors or by the shareholders. Directors typically are prohibited from voting on the approval of any contract in which they have an interest. If the contract is disclosed to the board and approved by the remaining directors, the contract is valid despite the director's interest.

With regard to the situation where a director or officer is not directly a party to a contract, but may have an interest in the contract, the term "material interest" is not defined in the legislation, there is no definition of a "material" contract or a "material interest" in a transaction, and there is little case law on point.[102] The concept of "material interest" will surely cover situations where the party to a contract was a spouse of the director or a family member, or where a spouse

[101] J. ANTHONY VANDUZER, THE LAW OF PARTNERSHIPS & CORPORATIONS 275 (2d ed. 2003).

[102] *Id.*

had a material interest. The courts will likely take a broad approach in determining whether there is a material interest, and will not require the interest to be purely financial.[103]

A less clear situation is where a director owns shares in the corporation which is the party on the other side of the contract. Academic commentators have argued that in this situation the contract, and the director's ownership interest, taken together, must be of sufficient size so that completion of the contract would have a significant effect on the value of the director's interest in the other corporation. This means, for instance, that if a director owns $1 million in shares in a large widely held bank, the statutory provisions would not govern a loan between the director's corporation and the bank, because the completion of the loan will have little or no effect on the value of the bank's shares.[104]

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

European Union

The need for companies to have independent directors, in part so that these directors can be assigned the task of reviewing proposed conflict-of-interest transactions, is addressed in a 2005 Recommendation of the European Commission on the role of non-executive or supervisory directors of public companies and on committees of the board of directors. The recommendation calls for public companies to have a "sufficient number" of independent directors "to ensure that any material conflict of interest involving

[103] KOEHNEN (2004), *supra* note 39, at 242-43.

[104] KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 755-56 (1999).

directors will be properly dealt with."[105] The recommendation does not include discussion of the standard of care or the standard of liability, either for independent directors who review a conflict-of-interest transaction, or for the persons who may engage in such a transaction and seek to obtain approval from the independent directors.

New Art. 43(7b) of the Accounting Directive (78/660/EEC)[106] requires firms to disclose information in the notes to their annual financial statements on transactions with related parties. To define a "related party," the Directive refers to International Accounting Standard (IAS) 24.9, which defines this term to include parties that control the firm or have an interest giving them significant influence, associates, joint ventures, key management personnel, close family members of or entities controlled or influenced by such parties, and benefit plans for the employees of the company or a related party.

France (with a note on Latvia)

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

[105] *See* Commission Recommendation 2005/162/EC, 2005 O.J. (L52).

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

transaction is not disclosed, it is voidable at the option of the company. More specifically, Articles L. 225-38 et seq. provide:

- Article L. 225-38: Any agreement entered into, either directly or through an intermediary, between the company and its general manager, one of its assistant general managers, one of its directors, one of its shareholders holding a fraction of the voting rights greater than 10% or, in the case of a corporate shareholder, the company which controls it within the meaning of Article L. 233-3, must be subject to the prior consent of the board of directors. The same applies to agreements in which a person referred to in the previous paragraph has an indirect interest . . . .
- Article L. 225-39: The provisions of Article L. 225-38 are not applicable to agreements relating to current operations entered into under normal terms and conditions. Such agreements are nevertheless made known to the chairman of the board of directors by the interested party unless they are of no significance to any party, given their objective or their financial implications. A list of such agreements and their objectives is sent to the members of the board of directors and to the auditors by the chairman.
- Article L. 225-40: The interested party must inform the board immediately upon becoming aware of an agreement to which Article L. 225-38 applies. They may not participate in the vote on the requested prior approval of the Board. The chairman of the board of directors shall advise the auditors of all agreements authorised and shall submit them to the general meeting [of shareholders] for approval. The auditors shall present a special report on the agreements to the meeting, which shall rule on this Report. The interested party may not participate in the vote and their shares shall not be taken into account for the calculation of the quorum and the majority . . . .

- Article L. 225-42: Without prejudice to the liability of the interested party, agreements referred to in Article L. 225-38 and entered into without the prior authorization of the board of directors may be cancelled if they have prejudicial consequences for the company. Nullity proceedings shall be time-barred after three years with effect from the date of the agreement . . . .

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

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

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

The concept of an indirect interest in a transaction is not defined in the law. Opinions in decided cases provide some guidance on the scope of this concept. For instance, there is an indirect interest where a director is also the dominant shareholder of the counterparty of the transaction,[107] or where the CEO of one company is also the CEO of the counterparty to the transaction.[108] However, one case finds that there was no indirect interest where the company engaged in business with another company established by the children of the CEO.[109] In our view, this case is problematic, because the involvement in the transaction of

[107] *See* Cass. com., Oct. 4, 1988, Bull. Joly, No. 681.

[108] Paris, June 26, 1990, Dr. sociétés, No. 269.

[109] Cass. com., Oct. 23, 1990, Bull. civ. IV, No. 254.

close relatives of the CEO or a member of the board of directors should be regarded as creating an indirect interest on the part of the CEO or board member.[110]

Germany

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

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

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

AktG § 89 requires supervisory board approval for loans extended by the firm to members of the management board if the amount of the loan exceeds the debtor's monthly salary. The resolution must specify the terms of the loan and must be passed no more than three months before the loan is

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

made. There are similar provisions for loans to other senior company officials who have the power to bind the company in its dealings with third parties (AktG §89 II), members of the supervisory board (AktG § 115 I), and spouses, partners, underage children and persons acting for the account of a management director, supervisory director, or other senior official (AktG § 89 III and § 115 II).

Korea

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

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

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

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

order to protect the company and the director against a lawsuit or adverse publicity.

In May 2000, a group of international consultants noted the weaknesses in Korea's regulation of conflict-of-interest transactions, and recommended that these transactions should be approved by non-interested directors and, for major related party transactions, by non-interested shareholders.[111]

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

> **Article 397 (Prohibition of Competing Business)**
> (1) No director shall, without the approval of the board of directors, effectuate for his own account or for the account of a third person any transaction which falls within the line of businesses of the company or become a member with unlimited liability or a director of any other company whose business purposes are the same as those of the company.
> (2) If any director has effectuated a transaction for his own account in breach of paragraph (1), the company may, by the resolution of the board of directors, deem such transaction as effectuated for account of the company and if he has effectuated a transaction for account of a third person, the company may demand the pertinent director to transfer any gain accrued therefrom.
> (3) The rights under paragraph (2) shall be extinct with the lapse of one year after the day on which such transaction has been effectuated.

[111] Bernard Black, Barry Metzger, Timothy O'Brien & Young Moo Shin, *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness*, 26 IOWA J. CORP. L. 537, 567-68 (2001) (Report to the Korean Ministry of Justice, May 2000), *available at* http://ssrn.com/abstract=222491.

United Kingdom

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

English courts have deliberately refrained from giving an exhaustive definition of a "conflict of interest," in order to be able to cope with new situations. The concern is that a bright-line rule could be evaded through clever transaction planning. The scope of what could be considered a conflict must be inferred from the cases. The basic concept is that a conflict of interest exists where there is any factor (usually, though not always, a financial factor) which might tempt a director or officer to act to favor that interest, at the company's expense.[112]

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

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

[112] *See* Conaglen (2005), *supra* note 61 (exploring the theoretical underpinning of the conflict of interest rules). This article addresses the rules applicable to fiduciaries in general, not just directors, but it is entirely relevant to company directors and officers.

must be solvent.[113] Finally, the board (if the charter so provides) or the shareholders can authorize a specific transaction after the transaction is completed, again provided that the board or the shareholders are fully informed and the company is solvent.[114] Sometimes, the term "ratification" is used to refer to authorization of a transaction after it has been completed.

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

These rules change if a company is insolvent or on the verge of insolvency. For an insolvent company, the board and shareholders lose their power to authorize or ratify a conflict-of-interest transaction. If the company is on the verge of insolvency, the courts restrict the ability of shareholders to authorize or ratify a conflict-of-interest transaction, in order to protect creditors.[115] The real interests of such a company are identified with those of creditors, rather than shareholders, because the creditors' claims on the company's assets rank ahead of the shareholders' claims.

Indirect interests are included in the set of interests which trigger the common law rules governing conflicts of interest. Plenty of examples can be found in even the very old cases. Early cases include *Re Cape Breton Co. Ltd.* [1885] 29 Ch. D. 795 (purchase by company of property in which its director had a beneficial interest under a trust, but not full ownership); *Transvaal Lands Co.* v. *New Belgium (Transvaal) Land & Development Co.* [1914] 2 Ch. 488 (director interested in a contract with another company in

[113] *See, e.g.*, N.Z. Neth. Soc'y v. Kuys, [1973] 1 W.L.R. 1126.

[114] *See, e.g.*, Gray v. New Augarita Porcupine Mines Ltd., [1952] 3 D.L.R. 1 (Can.).

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

which he held shares as trustee); *Aberdeen Railway Co.* v. *Blaikie* [1854] 1 Macqueen's House of Lords Appeals 461 (director interested in a contract with a partnership of which he was a member).

The common law rules on conflicts of interest are supplemented (not replaced) by statutory rules which apply to specific types of transaction in which the director has a conflict of interest.[116] One important set of these rules concern "substantial property transactions" between a company and a director or a person associated with a director (Companies Act 1985, §§ 320-322, 346, to be replaced by Companies Act 2006, §§ 190, 196, 254-256). Whether a transaction falls within the scope of one of these rules depends on the specific wording of the statute. The statute drafters did not try to cover all conflict-of-interest transactions, and instead relied on the common law rules to cover any transactions that were not specifically addressed in the statute.

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

- The common law rules potentially are easily modified by provision in a company's charter. It is therefore easy to remove power from the general meeting of shareholders. For example, if a company has a standard clause in its charter, similar to the default provision in Table A regulation 85, the board can approve a conflict-of-interest transaction involving a director. In theory, the board can do so even if the contract is a huge and vital one and even if there is reason to believe that the directors who decided the matter might have been influenced by the director who was interested in the contract. If such influence could be proven, then the approval by the purportedly

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

independent directors would not be effective; but proof of influence can be very difficult. Consequently, a more robust and mandatory mechanism, requiring approval by a shareholder meeting and not merely by directors, was considered to be appropriate for particularly risky transactions.

- The common law rules are not well suited to control the activities of persons who are not themselves directors, but are connected or associated with a director in some way. The common law rules can control these activities only if it can be shown that a director was acting on behalf of others. However, in practice, this is difficult to prove. As a result, a stronger mechanism for approval of transactions with persons having specified types of connections to the company or its directors has been instituted.
- For certain types of transactions, the risk of harm to the company may be high enough so that the fiduciary duties and remedies established by the common law may be insufficiently rigorous.

Public companies face additional regulation of conflict-of-interest transactions under the listing rules of the London Stock Exchange on "related party transactions."[117] Specific definitions are used as to define what constitutes a "related party" transaction. Broadly speaking, the definitions encompass situations where conflicts of interest amongst management are likely, or where substantial shareholders may be able to abuse their influence. The reasons for having this extra layer of rules are broadly similar to those which are said to justify the special rules discussed above which are included in the Companies Acts 1985 and 2006, but with the added element that formal control of those with influence over a company is more critical when the company's shares are widely held, which makes it more difficult for minority shareholders to respond to apparent conflict-of-interest transactions.

[117] LONDON STOCK EXCH. LISTING RULES, Ch. 10.

One problem is that directors and officers owe fiduciary duties to the company, and the company is the principal party entitled to enforce these duties, but the company is controlled by the directors. In theory, it has long been possible for shareholders to bring suit on behalf of the company (known as a "derivative" suit). However, in practice, the possibility to bring a derivative suit was narrowly limited by procedural rules. Moreover, recovery in such an action is for the benefit of the company as a whole, not the shareholder(s) bringing the action. Thus, shareholders often have limited motive to bring a derivative suit. In addition, the shareholders who bring the action bear the risk of paying most of the legal expenses of both sides if they lose, under "loser pays" English civil procedure rules. As a result, derivative actions have been very rare in the UK.[118] The Companies Act 2006 liberalizes the procedures for bringing derivative suits (we discuss these new rules in Subch. 8.1).

It is possible in some cases for a shareholder to bring a direct action challenging a conflict-of-interest transaction, relying on the unfair prejudice or oppression remedy.[119] This remedy was discussed above in the Canadian context. However, cases involving public companies are rare, because the economic incentives for a minority shareholder to bring such an action are limited.

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

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

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

United States

Transactions with directors and officers.

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

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

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

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

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

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

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

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

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

noninterested, and do not draw a distinction between affiliated outside directors and independent directors.

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

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

In principle, approval by a vote of disinterested shareholders will also shift the burden of proof to an unhappy shareholder to show lack of entire fairness. However, the usual practice is to seek approval by noninterested directors, rather than approval by shareholders.[120]

[120] The company laws of many states provide that a transaction involving a conflict of interest on the part of a director or officer is not void or voidable solely because it involves a conflict of interest, if certain procedural steps are followed. *See, e.g.*, DEL. CODE ANN. tit. 8, §144 (2007). One might think that this means that if these procedural steps are not followed, the transaction *is* void or at least voidable. This is not correct. Instead, these statutory provisions merely overrule an old common law doctrine, under which transactions *were* void or voidable solely because of the existence of a conflict of interest. This old common law rule has largely been abandoned, but the statutory provisions remain. For

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

For the most part, directors and officers do not face criminal liability for their conduct. One exception is completion of a conflict-of-interest transaction without disclosure to the board of directors. This can be seen as a form of theft, and can lead to criminal prosecution.[121]

Fair process

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

discussion of these confusing statutory provisions, see ROBERT C. CLARK, CORPORATE LAW § 5.2.1 (1986).

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

procedural requirement, which can be called "quasi-arms-length negotiations," the noninterested directors must have the opportunity to select and use their own legal and financial advisors, and must have the power to reject the transaction altogether.

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

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

The American courts' focus on the procedures that a company follows when approving a conflict-of-interest transaction is part of a more general American emphasis on procedure when judges review company decisions. Our judges are very reluctant to decide for themselves the substantive merits of a business decision. They often focus instead on whether the company followed good procedures. They then presume, within fairly broad parameters, that if proper procedures were followed and the decisionmakers

appear to be disinterested, the outcome should be accepted. For conflict-of-interest transactions, the courts recognize that good procedures sometimes camouflage a dirty transaction, so they are attentive to substantive fairness. For other transactions, in contrast, good procedures will permit a company to complete almost any transaction, no matter how foolish, by relying on the protection of the business judgment rule.

Derivative suits and the remedy for breach

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

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

In the United States, unlike many other countries, lawyers are allowed to charge contingency fees and each side generally pays its own legal expenses. Although the damages from a derivative suit are paid to the company, the shareholders' lawyers are paid directly, with payment coming most commonly from directors' and officers' insurance. In practice, the shareholders' lawyers are often

the principal beneficiaries from a derivative lawsuit. They act, in a way, as private policers of good company behavior.

The United States would surely get less vigorous enforcement of fiduciary duty if we had a different system for paying legal fees. How much less enforcement we would get is a difficult question. Whether we would be better off with fewer derivative suits is a question on which our scholars disagree.[122]

Summary and recommendations

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

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

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[122] For a skeptical view of the value of derivative suits, see Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991).

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

Second, it is necessary to address both direct and indirect conflicts of interest. An indirect conflict can arise, for example, when a director has a financial interest in another company, which engages in a transaction with the company of which he is a director. This financial interest can be held directly or it can be held indirectly, through intermediaries or through securities or other means which provide a financial interest without direct ownership.

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

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

Fifth, to be effective, the concept of conflict of interest must include not only directors and senior managers, but also controlling shareholders. The remedies available when a conflict arises may be different for members of the board of

directors or the executive organ than for controlling shareholders. In Canada, for example, transactions for which a controlling shareholder has a conflict of interest are addressed under the oppression remedy. In the United States, in contrast, these transactions are addressed by extending a limited duty of good faith to controlling shareholders.

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

Definition of conflict of interest

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

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

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

> A member of a company's board of directors, a member of the company's management, a controlling shareholder, or another person having a duty to act

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

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

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

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

appropriate approval of the conflict-of-interest transaction, and showing that the transaction was fair to the company.

Recommendations for improved functioning of the board of directors

Delayed approval of de minimis transactions

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

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

threshold amount, or (ii) the date of approval by the board of directors of the company's annual financial statements for the year in which the transaction was completed.

Subchapter 1.5. Conflict of interest for transactions with controlling shareholder

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

General comment

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

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

Russian context

The concept of "conflict of interest," while not defined by Russian corporate law, is nevertheless used in both legal precedent and literature. Some laws include individual provisions relating to the concept of "conflict of interest." For

example, the provisions of the JSC Law on self-interested transactions can be understood as covering a class of transactions which pose a risk of a conflict of interest, even though not all of these transactions will involve an actual conflict.

A definition of the concept of "conflict of interest" as it pertains to professional participants in the stock market is provided in a 1998 Decree of the Federal Commission on Securities.[123] Under this decree, a conflict of interest is a conflict between the material and other interests of a professional participant in the stock market (and/or his employees) and the client of the professional participant, as a result of which the action (inaction) of the professional participant (and/or his employees) results in losses or other adverse consequences for the client. The Code of Corporate Governance, which is advisory in nature, mentions but does not define conflict of interest (ch. 3, § 2.1.2): a conflict of interest provides grounds for doubting that a member of the board of directors will act in the interests of the company.

A conflict of interest can arise in various areas of the company's operations, including decisions by the company's management organs, where a member of these organs, or an important shareholder, has a financial or other interest in a transaction, transactions that affect the relative rights of majority and minority shareholders, and disputes between the company and its shareholders. In legal practice, the term "conflict of interest" is encountered most frequently in transactions involving a self-interest as defined in the JSC Law.[124]

[123] Decision of the Federal Commission on Securities No. 44 "On the Prevention of Conflict of Interest in the Performance of Professional Duties in the Stock Market" (Nov. 5, 1998) (Постановление Федеральной Комиссии по Рынку Ценных Бумаг от 05.11.1998 №44 «О предотвращении

The problem of "conflict of interest" can be resolved in two ways. First, by means of "disclosing and overcoming" it. For example, situations of potential conflict can be listed in the law and in a company's charter, and the company's management organs can then avoid these situations in the operations of the company, or approved by non-interested members of the management organs or by non-interested shareholders. This is the approach taken in the JSC Law.[125] Second, the law can provide remedies for shareholders or other aggrieved parties if a conflict of interest should arise, through compensation of losses or invalidation of the transaction.

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

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

F09-2729/2004-GK (Aug. 25, 2004) (Постановление Федерального Арбитражного Суда Уральского Округа от 25.08.2004 № Ф09-2729/2004-ГК); Decision of the Federal Arbitrazh Court of the North-Caucasian District No. F08-1780/2005 (Jun. 1, 2005) (Постановление Федерального Арбитражного Суда Северо-Кавказского Округа от 01.06.2005 № Ф08-1780/2005).

[125] We discuss the provisions the JSC Law on self-interested transactions *supra* in Subch. 1.4.

particular self-interested transaction, if he does not have a self-interest with respect to the transaction that is being considered.

With regard to the second, more general concept of independence, the Code of Corporate Governance ch. 3, § 2.2.1, provides a unified definition of an independent director; develops the criteria for designating directors as independent; recommends that an independent director, after seven years of performing his duties, should no longer be considered independent; and recommends the presence of at least three independent directors on the board of directors.[126]

An FSFM regulation, which applies to publicly listed companies, also defines director independence. To be considered independent, a director should not, when elected to the board and for one year prior to election, be an officer or an employee of the company; should not be a spouse, parent, child, brother or sister of any of the company's officers; should not be a government representative; etc.[127]

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

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

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

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

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

Canada

A minority shareholder who wants to challenge a transaction between a company and a controlling shareholder will probably have to apply for relief, under a statutory rule that allows shareholders in Canada, like their counterparts in the U.K., to bring a lawsuit seeking damages on the grounds that the minority shareholders' interests have been unfairly prejudiced by action by the corporation (CBCA § 241, OBCA § 249).[128] This form of relief, known in Canada as the "oppression remedy," is available for both private and public companies, but in practice it is used primarily by shareholders in privately held companies.[129]

In the context of private companies, there are numerous cases where "oppression" has been found where there has been a transfer of corporate assets to key shareholders without a fair price being paid to the corporation, there has not been a proper valuation of the assets or the asset transfer has left the corporation unable to pay its debts.[130]

The fact that a company's board of directors has endorsed a transaction between the company and a dominant shareholder is unlikely to affect the outcome of a suit based

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[128] *See* VANDUZER (2003), *supra* note 101, at 327.

[129] DENNIS H. PETERSON, SHAREHOLDER REMEDIES IN CANADA §§ 18.144, 18.208 (1989); Stephanie Ben-Ishai, *The Promise of the Oppression Remedy: A Review of Markus Koehnen's Oppression and Related Remedies*, 42 CAN. BUS. L.J. 450, 455 (2005); Stephanie Ben-Ishai & Poonam Puri, *The Canadian Oppression Remedy Judicially Considered: 1995-2001*, 30 QUEEN'S L.J. 79, 92 (2004) (noting that, of seventy-one oppression remedy cases launched between 1995 and 2001, only six cases, an average of one case per year, involved a public company).

[130] KOEHNEN (2004), *supra* note 39, at 129.

on the oppression remedy. This is particularly likely to be the case if the directors who approved the transaction were not fully independent of the dominant shareholder.

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

Controlling shareholders do not, in general, owe a fiduciary duty of loyalty to the corporation or to minority shareholders. Thus, breach of fiduciary duty by a controlling shareholder will probably not provide a basis for a minority shareholder to challenge a transaction by the company in which a controlling shareholder had an interest. Canadian courts impose fiduciary duties on controlling shareholders only in special circumstances, such as where one shareholder undertakes to advise another in circumstances where there is an element of trust and confidence between them.[131]

European Union

A new European Union directive (to be implemented by Member States by 2008) contains requirements for disclosure of conflict of interest transactions, including transactions with a controlling shareholder.[132] The directive amends several prior accounting directives. New art. 43(7b) of the Accounting Directive (78/660/EEC) requires firms to disclose in the notes to the annual accounts:[133]

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[131] MCGUINNESS (1999), *supra* note 104, at 879-80.

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

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

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

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

For the definition of who is a related party, the directive refers to International Accounting Standard (IAS) 24.9.[134] The definition includes parties that control the firm or have a significant influence over it, associates of these persons, joint ventures, key management personnel, close family members of or entities controlled or influenced by such parties, and pension plans for the benefit of the company's employees or the employees of a related party.

France

With regard to transactions between a company and a controlling shareholder, there are several protections included in French company law. First, as noted above, the directors who are not directly interested must approve the transaction. Second, if the controlling shareholder attempts to influence the directors' decision, this can be seen as an

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

abuse of majority power, and gives rise to liability on the part of the controlling shareholder.[135]

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

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

Germany

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

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

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

[136] BGHZ 97, 28, 33.

shareholders from such a transaction are made in bankruptcy.[137]

There is abundant case law on concealed distributions by companies to shareholders. Generally, a "concealed distribution" is defined as a transaction the company would not enter into with an independent third party.[138] According to the case law, there is no requirement that the plaintiff prove subjective elements (such as intention to harm the company) to establish such a claim.[139] Most of the cases on concealed distributions involve limited liability companies, but the concept applies to joint stock companies as well. A distribution to shareholders is permitted if, after the distribution, the firm's net assets (total assets minus total liabilities) exceed its stated capital. Joint stock companies can make distributions only through dividends. Thus, a distribution in another form is unlawful regardless of the level of the company's net assets.

In addition to these statutory provisions, several German Supreme Court cases indicate that there is a fiduciary duty among shareholders.[140] However, according to recent decisions, resolutions passed by a "qualified majority" (75% of the votes) may carry their justifying reason within themselves,[141] and courts have not examined the reasonableness of a delisting resolution.[142] Thus, there is a trend to reduce judicial control.

Even if a conflict-of-interest transaction with a controlling shareholder does not require special approval procedures, it

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[137] *See* Holger Fleischer, *Disguised Distributions and Capital Maintenance in European Company Law, in Legal Capital in Europe*, EUR. COMPANY & FIN. L. REV., special vol. 1, at 94 (2006).

[138] HÜFFER (2006), *supra* note 48, at § 57, ¶ 8.

[139] BGH NJW 1987, 1194, 1995; BGH NJW 1996, 589, 590.

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

[141] *See* BGH, BGHZ 76, 352; 103, 184.

[142] BGH, BGHZ 153, 57 (*Macrotron*).

may require disclosure. The disclosure requirements arise both under the European Commission directive, discussed earlier in this chapter, and under International Financial Reporting Standards.[143]

Korea

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

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

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

Major public companies. Under KSEA art. 191-19, a public company with total assets of 2 trillion Korean won or more (roughly U.S. $2 billion) must obtain board of directors

[143] *See* INT'L ACCT. STANDARD 24.22 (2002).

approval for a transaction between the company's largest shareholder (who is often a director) and the company, and provide information about the transaction to the next general meeting of shareholders held after the board of directors approves said transaction.

United Kingdom

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

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

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

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

United States

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

One important exception to this general rule involves a freezeout offer by the controlling shareholder for all minority shares. If the controlling shareholder can acquire 90% of the company's shares in the market, the controlling shareholder can then freeze out the remaining shares, with no direct duty to offer a fair price. The minority shareholders will still have an opportunity to obtain the fair value of their shares through an appraisal proceeding.[144]

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

For a transaction where a controlling shareholder would bear the burden of proving entire fairness, the burden can be shifted back to the plaintiff to show lack of fairness through approval by a disinterested decisionmaker. For the most part, the rules on disinterested approval are similar to those

[144] *See* Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 20 (2005).

for transactions in which a director or officer has a conflict of interest.

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

Summary and recommendations

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

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

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

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

the controlling shareholder, or his affiliated persons, engages directly or indirectly in a transaction with the company. It would largely be satisfied by ensuring that the conflict is disclosed in advance to the company and the transaction has been approved by non-conflicted members of the board of directors, is fair to the company, and has been approved in compliance with JSC Law chapter 11, if this chapter is applicable. See the proposed definition of good faith in Subch. 1.2.

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

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

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

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

General comment

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

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

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

unable to sell their shares to investors. But this is not the situation in any of the studied countries.[145]

Russian context

Liability of the individual executive organ for signing a securities prospectus

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

1) damages caused to a possessor of securities;

2) causation between the actions of the person who signed the prospectus containing unreliable information and the damages incurred; and

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

3) fault.

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

Liability of members of management organs for preserving confidentiality

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

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

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

The only liability specified in Civil Code art. 139 and Law on Commercial Secrets art. 10 with regard to employment or commercial secrets is that persons who obtain these secrets by "illegal methods" are liable to the company for damages. The liability of the person who disclosed the information is not clear. Thus, the only clear way for a company to hold

members of a company's management organs liable for disclosing confidential information would be to sign agreements with them on the non-disclosure of such information, which provide a damages or other remedy for breach. In practice, serious difficulties arise in determining the amount of damages, because the value of the divulged information is extremely difficult to calculate.

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

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

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

Canada

Analytically, directors' duties can be thought of as "gap fillers" parties would contract for under ideal market conditions. Practically speaking, however, in Canada the duties are rarely thought about in contractual terms. Instead, parties accept that directors have duties and

obligations set down by statute and common law and rarely impose additional duties by contract. The duties imposed by corporate law are generally not subject to being overridden by a contract between the company and a director or officer, or by the corporate charter.[146]

Directors can face civil liability under a wide range of laws, not just corporate law. Securities law generates more concern for directors of public companies than corporate law because there is greater potential for direct suits by shareholders.[147] The federal Income Tax Act § 227.1, in essence imposes a duty on directors to act with reasonable prudence to prevent failures by their companies to remit tax due. There apparently have been a significant number of cases brought under this provision, though probably most are against directors of small companies.[148] Whether large numbers of directors have been held liable is unknown at present. Outright default on income tax obligations will be a rare occurrence for public companies, absent an abrupt financial collapse. Typically, large companies go bankrupt after a period of losses, which means they are unlikely to owe large income taxes.

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

[146] CBCA § 122, OBCA § 134.

[147] *See* Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV., 1385, 1445-47 (2006).

[148] Martha O'Brien, *The Director's Duty of Care in Tax and Corporate Law*, 36 U. BRIT. COLUM. L. REV. 673, 676 (2003).

where directors have been held liable for unpaid wages have involved private companies.[149]

European Union

Duty of confidentiality

The statute governing the European Company (*Societas Europaea*, or SE) provides that the members of an SE company's management organs, including directors, are under a duty not to divulge any information concerning the SE, disclosure of which might be against the company's interests, except where such disclosure is required or permitted under national law provisions applicable to public companies or is in the public interest.[150]

France

General basis for liability

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

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

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

[150] Council Regulation 2157/2001, art. 49, 2002 O.J. (L294) 1 (EC).

Duty of confidentiality

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

Germany

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

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

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

> (3) The members of the management board shall in particular be liable for damages if, contrary to this Act:
>
> 1. contributions are repaid to shareholders;
> 2. shareholders are paid interest or dividends;
> 3. company shares or shares of another company are subscribed, acquired, taken as a pledge or redeemed;

> 4. share certificates are issued before the par value or the higher issue price has been fully paid;
> 5. assets of the company are distributed;
> 6. payments are made after the company has been insolvent or overindebted;
> 7. remuneration is paid to members of the supervisory board;
> 8. credit is extended;
> 9. in connection with a conditional capital increase, new shares are issued other than for the specified purpose or prior to full payment of the consideration.

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

Duty of confidentiality

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

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

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

Korea

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

that they took reasonable steps to become informed and were not aware of the false statements or material omissions.

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

In 2003, the KSEA was amended to introduce a requirement for certification of a company's financial statements by the CEO and the Chief Financial Officer, similar to one of the requirements of the Sarbanes-Oxley Act in the United States. The representative director or other relevant officers are obliged to confirm and sign the disclosure documents, including registration statements and annual, semi-annual and quarterly reports.[151]

United Kingdom

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

In practice, companies do not seek to impose additional liability on directors. Recent legislative changes have moved in the other direction, by clarifying and expanding the power

[151] KSEA art. 8, ¶ 4; art. 14, ¶ 1, No. 1-2.

of companies to indemnify directors against legal expenses if they are sued.[152]

There are various sources of civil liability for directors other than company law. Some of the more important can be summarized briefly. Under securities regulation, directors of U.K. public companies can be held liable to shareholders if the offering documents circulated in support of a public offering of securities fail to include required material or contain false or misleading disclosures.[153] Negligent misstatements in the annual accounts and other documents disseminated by directors of a U.K. public company can in theory form the basis for a suit by investors.

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

United States

Imposition of additional duties by contract

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

The United States is unique among the comparison countries in having a large number of lawsuits against directors. Due to the frequency of lawsuits, the United States is also unique in allowing companies to limit the monetary liability of outside directors in their charters. With regard to breach of the duty of care, a company may

[152] These changes, and the *Equitable Life* lawsuit against outside directors, which produced pressure for these changes, are discussed in Cheffins & Black (2006), *supra* note 147, at 1406-15.

[153] Financial Services and Markets Act 2000 § 90 (U.K.); Al-Nakib Invs. (Jersey) Ltd. v. Longcroft, [1990] 3 All E.R. (Comm.) 321.

limit or eliminate the monetary liability of outside directors, as long as the directors have acted in good faith.[154]

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

Other fiduciary obligations under corporate law

Directors are subject to a duty of candor in their communications with shareholders. This can be seen as separate from the duty of care and duty of loyalty, although the courts treat it as encompassed by these more traditional duties.[155] Directors can be seen as subject to a heightened duty of care when their firm receives a takeover bid from another firm. The courts have treated this heightened duty as a combination of the traditional duties of care and loyalty.[156]

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[154] DEL. CODE ANN. tit. 8, § 102(b)(7) (2007); MODEL BUS. CORP. ACT § 2.02(b)(4) (1984); *see also In re* the Walt Disney Co. Derivative Litig., 906 A.2d 27, 62-68 (Del. 2006) (discussing the meaning of the "good faith" exception).

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

[156] The duties of directors of target companies are complex, and beyond the scope of this Report. *See* RONALD GILSON & BERNARD BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 730-871 (2d ed. 1995).

Civil liability under other sources of law

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

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

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

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

Directors and officers face liability under pension law if their company has a pension plan that invests in the company's stock and the directors or officers are fiduciaries of the plan (the circumstances under which this is the case is a complex question that is beyond the scope of this Report) and are negligent in allowing the plan to invest in the

company's shares at a time when the share price has been inflated by the distribution of false and misleading information to the market.[157]

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

In addition to liability for breach of fiduciary duty, directors can be liable for payment of improper dividends, or for actions that exceed their authority. In a recent case, for example, the directors of a company approved a decrease in the exercise price of stock options granted by the company, after the company's share price had fallen, even though the company's stock option plan did not permit this. They settled the suit by agreeing to increase the exercise price back to its original level; the one director who had already exercised the stock options returned to the company the profit he earned as a result.[158]

Summary and recommendations

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

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[157] *See* Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1135-38 (2005).

[158] This case is discussed in *id.* at 1071-74.

Minor sources of liability under company law

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

Duty of disclosure

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

Duty of confidentiality

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

We understand that the scope of the obligation of directors to preserve confidentiality as to the company's business information has been a difficult one in Russia. The problem is that while there is a general obligation to

preserve the confidentiality of commercial secrets, the definition of commercial secrets consists of a list of specific types of information, and does not include all of the information that a company might want to keep as confidential.

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

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

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

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

decision to be adopted by the board. Within reason, company managers should be required to provide this information.

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

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

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

Liability under other sources of law

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

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

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

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

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

Subchapter 1.7. Damages for breach of duty

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

General comment

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

Russian context

The amount of damages for which a member of a company's management organs is liable depends on the nature of the legal relations between this person and the company. Russian law distinguishes between liability under civil law and liability under labor law. Civil liability compensates the aggrieved party for all losses it has borne, both actual losses and lost profit. In contrast, labor liability

generally covers only "real damages," which are limited to actual losses and do not include lost profit.[159]

Liability of the general director

Under Labor Code art. 277, the single-person executive organ of a company is liable for "direct real damages" to the organization.[160] The definition of "direct damages" in Labor Code art. 238 corresponds to the definition of real damages under Civil Code art. 15. However, civil liability is based on the broader concept of losses, also contained in Civil Code art. 15.

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

Liability of members of a company's management organs

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

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[159] We discuss the differences between civil liability and labor liability in Chapter 4.

[160] Under Labor Code art. 238, these liability provisions can extend to the members of the collegial executive organ if this is provided for in federal laws or the company's charter.

1) Real damages—expenses which a person has undertaken or will need to undertake to restore his violated right, plus any loss or damage to his property.

2) Lost profit—uncollected income which this person would have received if the norms of civil law had been complied with.

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

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

In determining the bases and amount of liability of members of a company's management organs, the usual terms of business dealings and other circumstances having importance for the case must be taken into account (JSC Law art. 71(3)). Widespread opinion exists that the members of management organs should not be held liable for business decisions which result in losses for the company. Instead, such members should be held liable for business decisions only if it is proven that their decisions were directly aimed at causing losses to the company. Otherwise, it is argued, if members of management organs are held liable for typical entrepreneurial decisions—including risky ones—that appeared rational in the company's particular situation, the company's operations will be severely hampered.[161] This

[161] *See* Telyukina (2005), *supra* note 95.

interpretation, however, contradicts JSC Law art. 71(2), which states that all losses (independent of the circumstances) due to a breach of the duty to act reasonably, in good faith, and in the company's interests are subject to compensation. In our view, the JSC Law should instead provide that the usual terms of business dealings should be taken into account not in determining the bases and amount of liability of the general director, but instead in determining "whether he conducted himself reasonably and in good faith and whether or not fault was present in his actions."[162]

Legal practice has shown that when the company seeks compensation for losses, this is most often from a single-person executive organ,[163] and the losses most often arise as a result of transactions entered into with a third party (e.g., the lease of a building or the sale of the company's assets on terms unfavorable to the company, unlawful use of the company's assets by the single-person executive organ, etc.).[164] Less often the executive organ is held liable for

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

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

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

inaction, for example in failing to timely pay taxes or make lease payments, as a consequence of which the organization loses property or suffers fines.[165] Even less often, the members of the board of directors or a managing organization are held liable.[166]

Canada

The usual measure of damages is loss suffered by the injured party. As discussed above, for a conflict-of-interest transaction, if a director fails to comply with the statutory provisions the contract will be voidable at the instance of the company (CBCA § 120(8), OBCA § 132(9)). The company or a minority shareholder can also apply for an order requiring the director to return to the company the profits received or gain realized. The wording of the OBCA appears to leave open the possibility that the corporation could sue for damages rather than a return of profits. The CBCA appears to restrict the remedies to setting aside the contract or an accounting for profits.

The case in which a director or officer takes personal advantage of a business opportunity that was also available to the corporation is another area where remedies can be an issue. If a director improperly exploits personally a business opportunity in which the company potentially had an interest, the company can seek a return of the director's profits even if the company likely would not have been able to exploit the opportunity itself.[167] The company can

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Округа от 24 декабря 2003 г. № Ф09-1180/03-ГК); Decision of the Federal Arbitrazh Court of the Ural District, No. F09-1180/03-GK (May 7, 2003) (Постановление Федерального Арбитражного Суда Уральского Округа от 7 мая 2003 г. № Ф09-1180/03-ГК).

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

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

[167] *See, e.g.*, Can. Aero Serv. Ltd. v. O'Malley, [1974] R.C.S. 592.

probably also seek compensation for losses (including loss of prospective profits from taking advantage of the opportunity).

There are no Canadian cases where judges have considered with care how directors' profits should be measured. If the issue were to arise in the future, the Canadian courts would likely treat English case law as relevant precedent.[168] Similarly, there are no Canadian corporate opportunity cases where a court has awarded compensation for losses suffered rather than a return of profits. If this issue were to arise in the future, again the Canadian courts would likely treat case law from other Commonwealth countries as relevant precedent.[169]

France

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

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

Germany

The standard remedy for a breach of fiduciary duty is damages incurred by the company (AktG § 93). General principles of German private law suggest that disgorgement of profits can also be a possible remedy in some cases. For instance, it may be the case that damages are assessed in a "normative" way, in order to protect integrity and morality, in measuring the proper amount of damages. This general

[168] *See, e.g.*, Ultraframe (UK) v. Fielding, [2005] E.W.H.C. 1638.

[169] *See, e.g.*, Warman Int'l v. Dwyer, [1995] 182 C.L.R. 544 (Austl.).

principal could permit an argument that profits from a conflict-of-interest transaction that was completed without proper approval by the company should be returned to the company. Another possible basis for a remedy of disgorgement of profits is if they are based on "spurious" enrichment under German Civil Code § 687(2) or unjustified enrichment arising from invasion of another's right under German Civil Code § 812(1).[170]

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

Italy

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

[170] *See* Mathias M. Siems, *Disgorgement of Profits for Breach of Contract: A Comparative Analysis*, 7 EDINBURGH L. REV. 27 (2003).

also includes the loss of business opportunity (Italian Civil Code § 2392(5)).

Korea

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

For the company to recover, it must prove that the director's breach of duty proximately caused the loss (Korean Civil Code art. 393). The Korean Supreme Court has ruled that the nature of the director's liability is similar to liability for breach of contract.[171] Therefore, the contract law measure of damages applies, rather than the tort law measure. This means, in practice, that the courts require a higher degree of certainty in assessing the amount of damages, and set a standard of proof that is often difficult to meet.

In the *Samsung Electronics* case, although the Seoul High Court accepted the plaintiff's claim that Samsung Electronics suffered a loss of 62.66 billion Korean won from the sale of certain shares, it opined that the directors' liability should be limited. According to the court, it would be proper for the company and the directors to fairly apportion the loss suffered by the company in connection with the directors' performance of their duties, in light of such factors as the type and size of business in which the company was engaged, the performance of the directors, and other circumstances. In this case, under the circumstances, the court viewed that it would be proper to limit the liability of the directors to 12 billion Korean won, approximately 20% of the loss suffered by Samsung Electronics. There was no statutory basis for this part of the decision, nor is it apparent from the decision why the court chose this amount of damages. The judgment seems to reflect the court's sense that to impose the full measure of damages (about U.S. $63

[171] Case No. 84-Daka-1954 (June 25, 1985).

million) on the directors would be unfair, taking into account the severity of their breach of duty. This judgment has the flavor of the decision of "equity" jurisprudence in a common law country, in which the court seeks to obtain a fair result, and is not limited by strict rules on the elements of a cause of action or on the measure of damages.

United Kingdom

The usual remedy for breach of duty is either the damages suffered by the company or the profits made by the director who has breached his duty, but not both. A transaction with a company which involves a conflict of interest is voidable at the option of the company.[172] However, the company's right to avoid the transaction can be lost in a number of ways:

1) the company, by action of the board of directors or potentially by the shareholders, approves the transaction after full disclosure by the director;

2) undue delay;

3) inability of the court to restore the parties to their previous position;

4) harm to the rights of an independent third party if the transaction were to be unwound; or

5) if the counterparty to the transaction with the company is someone other than the director (for example, another company in which the director has an interest), the transaction will not be voidable if the counterparty can prove that it was "innocent" (it had no knowledge or notice of the conflict). In practice, however, this will normally involve showing the transaction was fair, as a court will be quick to infer from a transaction disadvantageous to the company that the

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

> counterparty was not "innocent," but seeking to exploit the company.[173]

If a company cannot avoid a transaction for reasons beyond its control (i.e., reasons (3)-(5) above) it can instead claim from the director, at the company's election, *either* the loss it suffered *or* the profit the director made.[174]

Where a director takes advantage of a business opportunity that was also available to the company, the company may again elect to recover *either* the loss it suffered *or* the profit the director made, but not both.[175]

It is one thing to say a company may seek a recovery measured either by the losses caused to the company or the profits received by a director. It is quite another to measure and prove these losses or profits. Measuring losses is especially difficult. For the company to recover the loss, the company must show that the director's breach of duty *caused* the loss; and this is often difficult to prove. One common problem is that often the same loss might have happened anyway. For example, where a director takes advantage of a business opportunity that might have been available to the company, then the company has suffered loss only if it would have been able to exploit the opportunity profitably. This can be difficult to prove.[176]

For this very reason, companies most often elect to claim the director's profits. These are often easier to calculate, but proving the amount of the director's profits can also be difficult. The starting point is to show what profits (i.e., receipts less expenditure) the director made which were

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

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

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

[176] *See, e.g.*, Gwembe Valley Dev. Co. v. Koshy (No. 3), [2003] EWCA (Civ) 1048.

made possible by his breach of duty.[177] It is up to the director to try to show why that figure should be reduced—for example, to allow for his effort in turning a mere business opportunity into an actual monetary profit. The director is initially presumed not to be entitled to such an allowance, due to his breach of duty, but has the opportunity to persuade the court otherwise.

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

United States

For a violation of the duty of care, there is typically no profit earned by a director, so the measure of damages is loss suffered by the corporation. Recall, however, that it is extremely difficult to prove a breach of the duty of care, and that outside directors are usually not liable for monetary damages for breach of this duty. Thus, cases awarding damages are extremely rare. The last known case in Delaware was in 1985, and this case led directly to the amendment to the law to permit companies to eliminate the monetary liability of outside directors for breach of the duty of care.[178]

For a violation of the duty of loyalty, the most common basis for a lawsuit is a conflict-of-interest transaction

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[177] The difficulties in making even these calculations are illustrated by several recent cases. *See, e.g.*, *Murad*, [2005] EWCA (Civ) 959; Ultraframe (UK) Ltd. v. Fielding, [2005] EWHC (Ch) 1638.

[178] The exceptional case is Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). A recent extensive search for other cases in which outside directors paid damages under corporate law for breach of the duty of care found none, though the authors did not specifically search for cases in which there were monetary settlements paid for by insurance. Black, Cheffins & Klausner (2005), *supra* note 157.

entered into by the company. In this situation, the court has wide discretion in deciding on an appropriate remedy. The available remedies include:

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

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

Summary and recommendations

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

In a situation involving a conflict of interest, in which a director directly or indirectly, realizes a personal profit, the company should be able to obtain the greater of the harm caused to the company, or the profit earned by the director

and his affiliated persons. Often, the amount of profit will be easier to prove than the harm to the company. Often, too, the amount of profit will be larger. A strict measure of damages is appropriate to deter the completion of a conflict of interest transaction, without complying with a director's duty of good faith—and often without complying with JSC Law ch. 11 as well, since this chapter will apply to many conflict-of-interest transactions. The concept of losses contained in Civil Code art. 15(2.2) includes profit to the person who has violated a right as an alternate measure of damages. Thus, no change to the JSC Law is needed.

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

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

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

Often, if one director has breached a duty to the company, others will have done so as well, due to the collective nature

of many of the actions by the board of directors. In this instance, the usual rule is joint and several liability. This is the rule provided for in JSC Law arts. 71, 84. We do not recommend changing these provisions.

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

CHAPTER 3. LIABILITY RULES FOR DIFFERENT MEMBERS OF COMPANY MANAGEMENT ORGANS[179]

Should there be different liability rules for people holding different positions in a company? Should the duties of government-appointed directors be different than the duties of other directors?

General comment

With regard to whether different types of directors, should have different duties, or face different standards for when liability will be found for breach of duty, there are a number of distinct situations to be addressed:

- for a company with a unitary board, members of the board of directors who are also members of the management organ versus outside directors;
- for a company with a two-tier board, members of the management board versus members of the supervisory board;

[179] Chapter 2, Legal Nature of Relationship Between a Director and a Company, has been intentionally omitted. Footnotes are numbered consecutively, continuing from Chapter 1; the numbering differs from the full Report.

- the chairman of the board of directors versus other directors (for companies with a non-executive chairman);
- members of particular committees of the board of directors, such as the audit committee or the compensation committee;
- members of a formal management organ (such as the German management board) versus other senior managers who are not members of this organ; and
- directors appointed by the government versus other directors.

For government-appointed directors, we will address the situation of a company whose shares are partly held by the government and partly by minority investors.

Audit committee

In most of the comparison countries, the unitary board or supervisory board of a public company must include an audit committee with particular responsibility for the company's financial statements. This committee is required for public companies, banks, and insurance companies by a European Union directive, which must be implemented by member states by June 2008.[180] It is required in the United States by stock exchange rules and by the Sarbanes-Oxley Act. In Korea, an audit committee is required for banks and for large public companies (assets greater than 2 trillion Korean won, or about U.S. $2 billion).

Russian context

Civil Code art. 53 and JSC Law art. 71 contain unified norms of liability for all members of a company's management organs.[181] Thus, as a formal matter, the same

[180] *See* Council Directive 2006/43/EC, arts. 22, 24, 2006 O.J. (L.157) 87-107 (EC).

[181] We discuss these norms *supra* in Chapter 1.

norms apply to both executive and non-executive members of the board of directors, and the same norms apply to the individual executive organ, or the members of the collegial executive organ, as apply to directors. In practice, courts can interpret these norms differently as they pertain to the conduct of different members of a company's management organs.

One problem area involves directors who are appointed by the State. Under JSC Law art. 71(6), they have the same liability as other directors. This approach to the liability of state representatives, however, is problematic. Appointments to position on a company's board of directors can be made for State employees on the basis of a decision of the President of the Russian Federation or, for other citizens, on the basis of a contract on representation of the State's interests. A State representative must seek written approval from State bodies before voting as a member of a company's board of directors on specific important questions, specified in the decision appointing this person, or in the contract between the State and this person. If some of a company's shares are held in federal possession, representatives of the Russian Federation in a company's management organs shall carry out their duties on the basis of written directives of the Federal Agency on the Management of Federal Assets.

Thus, in practice, a State representative, in adopting decisions as a member of the board of directors, does not express his own will but instead merely informs others of the will of the State. The director also acts in the interests of the State, rather than the interests of the company. It seems unjust and ineffective to hold such persons liable for decisions that they do not themselves adopt. Moreover, it will be practically impossible to hold liable a State representative who conveys a decision made by others, because one cannot prove either fault guilt or a lack of good faith on the part of the State representative. As a result, no one will be liable for decisions adopted by a State representative, whether or not these decisions advance the company's interests.

Canada

Different types of directors

Canadian corporate law provides for a single, unitary board. As a result, there is no formal basis in statutory law for distinguishing between the liability rules applicable to different types of directors—for example, between executive and non-executive directors. Court decisions interpreting the fiduciary duties of directors also have generally not established different standards of liability for persons in different positions, whether the difference in question is inside director versus outside director, chairman versus other directors, or committee members versus other directors.

Canadian corporate statutes typically require public companies to have a minimum number of outside or non-executive directors (three outside directors under CBCA § 102; one-third of the board under OBCA § 115). The relevant statutes do not distinguish in any way between the liability of outside directors and other directors.[182] Canadian corporate law explicitly authorizes the board to delegate some of its managerial duties to board committees and to a "managing director" (CBCA § 115, OBCA § 127). The board will retain overall responsibility for managing the corporation, but the directors who have delegated these duties will, under normal circumstances, be entitled to rely on the persons with primary responsibility for these duties to carry out their duties honestly and responsibly.

Despite past trends, it is possible that in the future Canadian courts will begin to distinguish between different types of directors when ascertaining liability. In *Re Standard Trustco*, a 1992 decision of the Ontario Securities Commission (OSC) under securities law, the OSC implicitly acknowledged that a lesser degree of knowledge and diligence might be appropriate for outside directors, due to their part-time status, but said outside directors should

[182] MCGUINNESS (1999), *supra* note 104, at 827.

question management sufficiently to oversee properly a company's operations and disclosure. The OSC also indicated that a company's chairman of the board and the members of its audit committee could bear greater responsibility than other directors. This was not because they were required to meet a higher legal standard but rather because they will have greater knowledge of a company's circumstances than other directors.

The CBCA contains a "due diligence" defense, which is available to directors who otherwise might be held liable for breaching statutory provisions regulating the payment of dividends and other specified transactions (CBCA § 123). A similar protection is also often available under other statutes, including tax law and employment law. Typically, when legislation provides a due diligence defense, a director or officer must show that he did not know of the breach by the company despite having been reasonably diligent in carrying out his duties, in order to avoid liability. One might expect, with support in at least one tax case, that executives will find it more difficult to rely on a due diligence defense than outside directors because the executives direct involvement in running the company will make it difficult for them to claim that they were not aware of the company's lapse in compliance, despite reasonable diligence, because they will be expected to be familiar with the company.[183]

Government-appointed directors

Canadian corporate legislation does not contain special legal principles governing the duties of a government-appointed representative who is a director of a company which also has private shareholders. A government-appointed director would likely owe the corporation the same duties as other directors. This would be consistent with the general rule that a director nominated by a particular shareholder owes the same duties to the corporation as any

[183] *See* Soper v. R., [1998] 1 F.C. 124 (Can.).

other director.[184] However, there is no case specifically on point.

There is some case law suggesting judges are becoming more willing to recognize the commercial realities of life and permit a nominee director to protect the interests of those who have appointed him.[185] If this were to become the law, it also might provide some protection for a government-appointed director who acts in the interests of the government rather than in the interests of the company. Nevertheless, a director who is nominated by the government to serve on the board of a private corporation would be well advised to proceed very cautiously, and perhaps to resign if his obligation to the government appears to conflict with his obligation to the corporation.

France

One-tier board

The main provision on liability of directors, for a company with a one-tier board, is Code de Commerce art. L. 225-251, which states:

> [T]he directors and the CEO shall be individually or jointly and severally liable to the company or third parties either for infringements of the laws or regulations applicable to public limited companies, or for breaches of the memorandum and articles of association, or for tortious or negligent acts of management. If more than one director, or more than one director and the CEO, have participated in the same acts, the Court shall determine the share to be contributed by each of them to the compensation awarded.

The wording of this rule does not distinguish between different types of directors, nor does it contain special rules

[184] *See, e.g.*, 820099 Ontario Inc. v. Harold Ballard Ltd., [1992] 3 B.L.R.2d 113 (Ont. Div. Ct.).

[185] MCGUINNESS (1999), *supra* note 104, at 727.

for the CEO or for the chairman of the board. However, its application depends on the powers, duties, and nature of the corporate organ to which they apply. For instance, the *président directeur general* (PDG), who serves as both CEO and chairman, may bear responsibility for typical management errors.[186] The reference point for the standard of care applicable to a specific director standard is that of a director of the same category,[187] meaning in this instance other persons holding the position of PDG. Other directors may not be held to the same standard of liability as the PDG. Conversely, an unpaid board member will typically be held to a less strict standard of care than a director who receives compensation.[188] It is unclear whether employee representatives on the board of directors are subject to the same standard of liability as directors elected by shareholders.[189]

For senior executives who are not members of the board of directors, such as assistant general managers, article L. 225-251 does not apply. Their liability is therefore based on the general liability rules established in the French Civil Code.[190]

Two-tier board

Under Code de Commerce art. L. 225-256, the liability of members of the management board is as stated in article L. 225-251, which is quoted above. The members of the supervisory board are subject to a narrower provision, under

[186] *Cf.* LEFEBVRE (2006), *supra* note 45, at ¶ 8740.

[187] GUYON (2001), *supra* note 42, at ¶ 459.

[188] TERRE ET AL. (2002), *supra* note 43, at ¶ 061-09.

[189] *Compare* LEFEBVRE (2006), *supra* note 45, at ¶ 8490 (stating that employee representatives are subject to the same standard) *with* GUYON (2001), *supra* note 42, at ¶ 459 (suggesting that one cannot require the same standard of a low-ranking employee with a seat on the board as one can for a representative elected by shareholders). However, employee representatives who sit on the board of public-sector companies are apparently subject to a relaxed standard of liability.

[190] LEFEBVRE (2006), *supra* note 45, at ¶ 8824.

which they are not liable for acts of management. Code de Commerce art. L. 225-257 states:

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

Committees of the board of directors

The establishment of committees is recommended in the French Corporate Governance Code and almost all public companies have an audit committee and a compensation committee.[191] However, these committees have merely an advisory function. For instance, the French Supreme Court has held that the board of directors cannot delegate its power to determine the remuneration of executives to committees.[192] Due to this limited role of committees, the possibility of a different standard for liability of committee members has not yet become an issue in France.

Government-appointed directors

There is a general decree on public sector companies, which are the only companies which would be expected to have government representatives.[193] The relevant companies

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[191] *Cf.* Sylvie Hebert, *Corporate Governance "French Style"*, 2004 J. BUS. L., 656, 663 n.47 (2004); *see also* LEFEBVRE (2006), *supra* note 45, at ¶ 8836 (stating that committees are often formed to comply with demands of foreign investors). As noted above, a new E.U. Directive requires that a public company have an audit committee.

[192] Cour de Cassation, Quot. Jul., July 27, 1995, p. 4.

[193] Loi no 83-675 du 26 juillet 1983 relative à la démocratisation du secteur public (as amended); *see also* Dubois, *Rev. sociétés* 1986, 47 (responsabilité civile des diregeants des sociétés anonyme du secteur public).

are explicitly mentioned in this decree. Under Article 5 of this decree, the board of directors or the supervisory board of these companies shall include members elected by the shareholders, and state representatives (the number of which is established by decree) and employee representatives. Under Article 11 of the decree, state representatives do not receive any remuneration for their board membership, apart from their usual pay for government service. Under Article 22 of the decree, employee representatives also do not receive additional compensation. Furthermore, this article states that in determining the liability of employee representatives, the courts should take into account that they do not receive any compensation, and they should never be found to be jointly liable with directors who are elected by the shareholders.

One infers, from the explicit inclusion of special rules on the liability of employee representatives in the decree, and the absence of special rules on the liability of state representatives, that the ordinary rules of directors' liability apply to state representatives. Recall, however, that these general rules do permit the degree of care to vary depending on the position held by a director, and on whether or not the director receives compensation. These factors suggest that, if a case were to arise, the courts might apply a lesser standard of care to state representatives than to shareholder representatives.

In some public sector companies, state representatives have only a non-voting seat on the board. For example, the decree on the *Société Nationale Elf-Aquitaine*[194] stipulates in Article 2(1):

[194] Decree No. 93-1298 (Dec. 13, 1993). The European Court of Justice has held that the articles of this decree which relate to "golden shares" violate Art. 56 of the European Treaty (freedom of capital). Case C-483/99, Comm'n v. France, 2002 E.C.R. I-4781. *See also* OXERA CONSULTING, SPECIAL RIGHTS OF PUBLIC AUTHORITIES IN PRIVATISED EU COMPANIES (2005) (report prepared for the European Commission), *available at* http://ec.europa.eu/internal_market/capital/docs/2005_10_special_rights_full_report_en.pdf.

> [T]wo representatives of the State, appointed by decree, shall sit on the board of directors of the company, without entitlement to vote. One representative shall be appointed on a proposal by the Minister for Economic Affairs and the other on a proposal by the Minister for Energy.

Because these members of the board have no voting rights, as a formal matter they cannot affect the company's decisions and thus it is unclear whether they can be found liable for a breach of the duty of care. They could presumably still face liability if they are involved in a conflict-of-interest transaction. We are not aware of judicial decisions which assess the circumstances under which state representatives in public sector companies should be liable for breach of duty.

Finally, there may be companies where the state is a controlling shareholder, but the company is not specifically covered by the decree on public sector companies. Here, as with other companies, the directors are elected by the general meeting and the general rules on directors' duties should apply.

Germany and Austria

Different types of directors

German joint stock companies have a two-tier board. However, the liability provision that governs members of the supervisory board simply refers to the liability provision that governs members of the management board. For supervisory directors, AktG § 116 I provides:

> Section 93 concerning the duty of care and responsibility of members of the management board applies correspondingly to the duty of care and responsibility of the members of the supervisory board.

There are no additional statutory rules, and there is apparently no case law in Germany addressing whether there should be differences in the standards of care

applicable to management directors as compared to supervisory directors. However, there appears to be unanimous agreement in the literature that the duties of the members of the two boards are the same in principle, although they differ in practice due to the different tasks assigned by the law to the two boards. This can be paraphrased by saying that members of the supervisory board owe the duty of care and responsibility of an orderly "surveillant."[195] Presumably, the care required of supervisors, who are not full-time employees, is less than the care required of the full-time executives charged with managing the business. At the same time, according to the German Supreme Federal Court, every member of the supervisory board must have the ability to understand regularly occurring business transactions.[196] The same standard applies to shareholder and employee representatives on the supervisory board.[197]

With regard to differences between management directors and supervisory directors, the Austrian Supreme Court (OGH) has stated that the supervisory board's sphere of activity is smaller than that of management. The authority of the supervisory board is largely restricted to supervision of the management board, both as to past actions and expected future actions, the fulfilment of certain duties in the event of a financial or other crisis (such as putting pressure on managers to initiate insolvency proceedings), and review of financial statements. One can expect its members to spend a much smaller amount of time.[198] At the same time, members of the supervisory board must be able to understand financial statements and the auditor's report.[199]

Within the supervisory board or the management board, there are no statutory rules concerning different standards

[195] Peter Doralt, *Haftung und Schadenersatz*, *in* ARBEITSHANDBUCH FÜR AUFSICHTSRATSMITGLIEDER 721, 725 (Johannes Semler ed., 1999).

[196] BGHZ 85, 293, 295-296.

[197] HÜFFER (2006), *supra* note 48, at § 116, ¶ 2.

[198] OGH 1 Ob 144/01k.

[199] OGH 8 Ob 262/02s.

of liability for directors with different tasks. In particular, there is apparently no difference in the standards applicable to the chairman of the supervisory board, as compared to other members of the supervisory board. However, individual supervisory board members may be held to a heightened duty of care if they were appointed because of specialized knowledge or abilities, for example if they are members of a specific profession[200] (for example, a certified public accountant).

With regard to the management board, where it is expected that certain tasks will be assigned to individual members, it is typically said that a residual duty to supervise remains with all of the members.[201] This same principle should apply to the supervisory board.

Committees of the Board of Directors

Members of committees of the supervisory board or the management board are generally considered to be subject to a heightened duty of care with respect to tasks within the authority of the committee.[202] The remaining members of the board presumably have a correspondingly lower duty, but this does not entirely relieve other directors from their responsibility to critically evaluate the outcome of the committee's deliberations.[203]

In Austria, the supervisory board of a public company must include an audit committee, which must include a member who is a "financial expert," and can be expected to have specialized knowledge in finance, accounting, and financial reporting. (Austrian AktG §92(4a)). This is a new requirement, adapted from the similar requirement adopted for United States companies in the Sarbanes-Oxley Act. It is

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[200] LG Hamburg, 2 Zeitschrift für Wirtschaftsrecht und Insolvenzpraxis 194, 197 (1981).

[201] *See, e.g.*, BGHZ 133, 370, 377-378; HÜFFER (2006), *supra* note 48, at § 93 n.13a.

[202] Doralt (1999), *supra* note 195, at 732.

[203] *See* 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ, § 116 (Johannes Semler), ¶¶ 56-65 (Bruno Kropff & Johannes Semler eds., 2d ed. 2004).

not yet clear whether the financial expert will be subject to an increased duty of care when reviewing the company's financial statements.[204]

Managers who are not members of the management board are not normally discussed within the context of director's liability in Germany and are not subject to §93. Generally, their duties are determined by the contract of employment and by the general provisions of civil law. According to case law, employees will generally not be liable for the full amount of damages, and instead will be liable only in part, with the amount of liability depending on their degree of culpability (gross or slight negligence, with no liability for excusable mistakes), and general considerations of fairness (which include factors relating to the employee tasks, his family background, age, and so on).[205]

In Austria, similar rules have been codified in a special act which addresses the liability of employees who are not directors.[206] The act is commonly held not to apply to directors, because they are not considered employees.[207]

Government-appointed directors

Under § 4 I of the so-called *VW-Gesetz* (*Volkswagen* Act), each of the Federal Republic of and the State of Lower Saxony is entitled to appoint two members to the supervisory board of Volkswagen AG, as long as those political entities remain shareholders. However, there are no special provisions governing these directors' duties, so one may assume that their duties are the same as those of other members of the supervisory board.

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[204] As noted above, a new E.U. Directive makes an audit committee mandatory for a public company.

[205] *See, e.g.*, 1 ERMAN BÜRGERLICHES GESETZBUCH, § 610 (Stefan Edenfeld), ¶ 340 (Harm Peter Westermann ed., 11th ed. 2004).

[206] Dienstnehmerhaftpflichtgesetz, BGBl 1965/80, amended by BGBl 1983/169 (Austria).

[207] *See* KOMMENTAR ZUM AKTIENGESETZ §§ 77-84 (Rudolf Strasser), ¶ 99 (Peter Jabornegg & Rudolf Strasser eds., 4th ed. 2001-2006).

There is an exception relating to directors' duty of confidentiality. Under AktG § 394, members of the supervisory board who were appointed or elected on behalf of a government authority (such as the federal or state government or a municipality) are not subject to the usual confidentiality restrictions that govern other directors, with regard to the reports they submit to that authority, assuming there is a legal basis for the reporting requirement. The exception does not cover business secrets that are not relevant to the purpose of the report. To compensate for this exemption, AktG § 395 provides that the government officials who receive these are subject to a duty of confidentiality covering the information they receive.

In Austria, the *ÖIAG-Gesetz* of 2000 provides that when vacancies arise in the supervisory board of ÖIAG (the parent company of Austria's nationalized industries, which now function as a privatization agency), the new directors are elected by the remaining board members in compliance with certain criteria stipulated by statute. Apparently, the idea is to allow ÖIAG to have a board that is relatively free of political influence, so that it can pursue privatization without constant political intervention. There are no special provisions on board members' duties or liability.

Korea (and a note on Japan)

Executive and non-executive directors

In Korea, executive directors and non-executive directors are generally subject to the same duties and potential liabilities. The Japanese Supreme Court, in its decision of May 22, 1973, also ruled that there should not be different rules for executive directors and outside directors. However, according to the case law and leading scholarly opinions in Korea as well as in Japan, outside directors are subject to slightly reduced duties of care in monitoring the employees of the company.[208]

[208] CHUL-SONG LEE, CORPORATE LAW 584-86 (12th ed. 2005) (Korean).

In contrast to the situation in the United States, where directors face similar duties as do officers who are not members of the board of directors, the liability rules established by Korean corporate law apply only to directors. As Korean companies have added outside directors to their boards, partly to meet legal requirements, more responsibility and authority is falling on officers who are not directors. The Korean government is considering expanding the coverage of the liability rules to include these officers through an amendment of the KCC.

At present, Korean companies have a unitary board structure, and there is no formal basis for a difference in the standard of liability for inside and outside directors. However, the proposed amendments to the KCC include an option to establish a two-tier board system, with a separate management board and supervisory board. If this proposal is enacted, the potential for members of the management board and members of the supervisory board to be subject to different fiduciary duties or different liability rules may become an issue.

Directors of financial institutions

Directors of financial institutions may be subject to a stricter liability regime. According to the Korean Supreme Court, the role of banks differs from that of other companies.[209] Banks are required to contribute to the stability of the financial markets and to the development of the national economy. Bank directors must fulfill their fiduciary duties with utmost (enhanced) care in (1) the protection of the properties of depositors; (2) the maintenance of credit systems; and (3) the promotion of efficiency in finance brokering. The court set out the following criteria by which the directors of the banks were to assess whether to grant loans: (1) the terms and conditions of the loan; (2) the loan amount; (3) the repayment plan; (4) the existence of collateral and its substance; (5) the status of

[209] *See* Korea First Bank, Case No. 2000-Da-9086 (2002) (S. Korea).

the debtor's assets and business operations; and (6) the debtor's future business prospects. This ruling enhances the fiduciary duties of directors of financial institutions in Korea, compared to their counterparts in other companies, and instructs them that part of their task is to review the loans made by the bank.

Government representatives

Korea has a small number of partially privatized enterprises, which were formerly state-owned, in which the government still holds a significant share position. Special laws govern the conduct of directors of these state-owned enterprises. As far as the liabilities of directors are concerned, the standards are the same for government-elected directors and other directors.

The Korea Deposit Insurance Corporation (KDIC) investigates the actions of directors of insolvent banks and frequently files damages claims with the court against former directors (and controlling shareholders) of an insolvent financial institution who may be responsible for the failure of the institution.[210] The procedure for a suit by the KDIC is available for both state-owned and privately owned banks, but in practice, most of the failures of financial institutions involved government-owned banks, which went bankrupt at the time of the East Asian financial crisis. As of the end of 2002, the KDIC had sued 4661 former directors and other employees of insolvent financial institutions for a total of 1296 billion Korean won (approximately U.S. $1.3 billion). There is no publicly-available data on the outcome of the litigations and actual recoveries. Still these lawsuits make it clear that government-appointed directors face the same risk of liability as other directors—and perhaps more due to public outrage if their company fails.

[210] Korean Depositor Protection Act, art. 21-2.

United Kingdom

There is no provision in English law requiring a company to have "independent" or "outside" directors. (These terms are treated as synonymous.) However, the Combined Code on Corporate Governance §A.3.2 (2003 and 2006 editions) recommends that a listed company that is within the FTSE 350 have at least half its board comprised of independent directors. The Code is not law, however: a company listed on the London Stock Exchange must only explain to the market whether and how far it has complied with the Code.[211]

In the U.K., all directors are held to the same legal standards, unless an Act of Parliament or specific regulation draws a distinction between them, which very rarely happens.[212]

Of course, the standards applied to all directors, such as "reasonable care and skill" will vary in their practical application, because a full-time executive director can reasonably be expected to do more (and better) than a non-executive (i.e., outside), who usually spends only a small part of his time on the company's business. As the courts have put it, "There is a considerable measure of agreement about the duty owed in law by a non-executive director to a company. In expression it does not differ from the duty owed by an executive director but in application it may and usually will do so."[213]

In an Australian case (which would be regarded as persuasive evidence of English law), a judge has raised the possibility that the non-executive chairman of a company should face stricter duties than other directors. However, the judge still approached the issue primarily by regarding

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[211] LONDON STOCK EXCH. LISTING RULES §§ 9.8.6, 9.8.7, 9.8.10.

[212] *See* Daniels v. Anderson, [1995] 16 A.C.S.R. 607 (Austl.) (approved and adopted in England in *Re* Barings plc (No. 5), [1999] 1 B.C.L.C. 433, 486-89 (H.C.), *upheld*, [2000] 1 B.C.L.C. 523, 534-35 (C.A.)).

[213] Equitable Life v. Bowley, [2003] EWHC 2263 (Comm.) (S. Africa), [2004] 1 B.C.L.C. 180, ¶ 35 (per Langley, J.).

the chairman as having greater responsibilities *as a matter of fact*, rather than due to a different legal standard.[214]

To summarize, the distinction between executive and non-executive (outside) directors in England involves their functions, not the legal standards they are to meet in performing those functions. Applying the same standards to different functions can, naturally, result in different results.

Government-appointed directors

There are no differences in the standards of liability applicable to government-appointed directors, versus other directors. Directors, whoever appoints or elects them, are liable to the company in the same way.[215] Moreover, the government owes no duties to the company simply by virtue of making the appointment. The same is true for a major shareholder who is able to arrange for a representative to be elected to the board.[216]

A director appointed by a specific shareholder or interest group *may* take the interests of that group into account *but only so far as consistent with the best interests of the company.* If there is a conflict between the interests of the shareholder or entity whom the director represents and the interests of the company, the director will be well advised to abstain from voting. If the director participates in a decision which raises such a conflict, the rule is clear that the director breaches his duty by voting to favor the interests of the shareholder or entity whom he represents over the interests of the company.[217]

If the shareholder or other interest that a director represents attempts to coerce the director into voting to favor

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[214] *See* ASIC v. Rich, [2003] NSWSC 85, [2004] 44 A.C.S.R. 341, ¶ 61 (per Austin, J.).

[215] *See* Bennetts v. Bd. of Fire Comm'rs of NSW, [1967] 87 W.N. (NSW) 307; Charterbridge Corp. Ltd. v. Lloyd's Bank Ltd., [1970] Ch. 62, 74-75.

[216] *See* Kuwait Asia Bank EC v. Nat'l Mut. Life Nominees, Ltd., [1991] 1 A.C. 187.

[217] *Charterbridge*, [1970] Ch. 62, 74-75.

its own interests over those of the company, it can potentially be liable as well. However, such an attempt is very much a matter of specific fact that must be proven and will often, in practice, be difficult to prove.

As a factual matter, government-appointed directors are rare in the U.K., following the privatizations and Thatcher reforms of the 1980's.

United States

Inside versus outside directors

There is no difference in theory between the fiduciary duties of inside and outside directors—both are equally subject to the duty of care.

When it comes to liability for breach of the duty of care, in contrast, in one sense, there is a large difference between the liability of inside and outside directors. This is due to the permission provided to companies in corporate statutes to adopt a charter provision that limits or eliminates the monetary liability of outside directors for breach of the duty of care, so long as the directors have acted in good faith. Assuming a company adopts a corresponding charter provision eliminating this liability—and almost all public companies have done so—inside directors are potentially liable for breach of the duty of care, while outside directors are not.

In another sense, there is no real difference in the potential liability of inside and outside directors—both are almost never liable for breach of the duty of care. The reason lies in the separate defense provided by the business judgment rule, which provides that if a director acts on an informed basis and in good faith, the courts will not inquire into the merits of the decision that was taken.

The reported cases include a small number of decisions to the effect that the outside directors did not satisfy their duty to become reasonably informed, and thus did not benefit from the business judgment rule, which in turn allows scrutiny of their decision, and allows the court to find liability if the directors reached a decision in a grossly

negligent manner. It is conceivable in theory, but far less likely in practice, due to the different nature of an inside director's job, that the inside director will be so ill informed that he will not satisfy the prerequisites for application of the business judgment rule. The same will hold true for corporate officers, who are subject to the same fiduciary duties as directors.

The net result is that, absent a conflict of interest, neither inside nor outside directors will be found liable for breach of fiduciary duty. This logic also applies to the potential for differences between directors who serve on particular committees, and to differences between ordinary directors and the chairman of the board. Whatever arguments one might construct in theory for why different standards might make sense are meaningless, in the face of an overall regime in which, as a practical matter, no director is ever found to face monetary damages for violating the duty of care.

For transactions involving a conflict of interest, there is no difference in the legal standards applied to inside and outside directors, and it is difficult to imagine a strong policy reason for such a difference to exist.

Directors of banks

Directors of banks face special risks for two reasons. First, they are subject to a duty of care that derives from banking law. While this duty is similar to the duty of care under corporate law, there is no ability of the bank to limit or eliminate the monetary liability of outside directors.

Second, the government insures bank deposits, and the deposit insurance agency has been willing to bring lawsuits against the former directors of insolvent banks, seeking recovery of damages, in situations in which a private shareholder would likely conclude that the potential recovery does not justify the expense of litigation. Such lawsuits have been brought against both inside and outside directors of failed banks.

Government directors

The political climate in the United States is strongly hostile to government ownership of business enterprises. When government ownership exists, it is (almost) invariably 100% ownership, and then the question of liability of government-appointed directors to the corporation or to outside shareholders does not arise.

There are a very small number of government-sponsored enterprises, but they operate under a specialized statute, and so their experience is not relevant to the rules governing ordinary business corporations.

For ordinary business corporations, one would have to search very hard to find an instance where a government representative is elected as a director, and there might be no such instances to be found at all. There is no case law discussing the liability of such a hypothetical government-elected director.

Summary and recommendations

We do not recommend establishing different standards of liability for different directors, depending on their positions, or on whether they serve on particular committees of the board of directors. The very complexity of the task, if one were to begin to draw distinctions between different types of directors, counsels against beginning the effort. The dominant approach in other countries is also not to draw distinctions between different types of directors, or between directors and senior managers.

For the most part, in our judgment, the same duties, and the same standards of liability should apply to all directors, with the following nuances, and with some need for special treatment of government-appointed directors.

Duty of care / reasonableness

Other countries do not draw a formal distinction between the degree of care or reasonableness expected of an executive versus a non-executive director. As a practical matter, however, executives are likely to face more severe scrutiny as

to whether they devoted adequate attention to an important business issue than non-executives, simply because of the differences in their roles. The same will be true, to some extent, for decisions that are adopted or recommended by a committee of the board of directors, even if the committee's recommendation is approved by the entire board. Thus, as a practical matter, members of the audit committee will be expected to be more fully informed as to issues involving a company's financial statements, members of the compensation committee will be held to a higher standard for decisions involving executive compensation, a non-executive chairman may be held to a higher standard in general than other outside directors, a brand-new director will not be expected to know as much about the company's business as a long-serving director, and so on. We believe that distinctions of this sort do not need to be stated in the law, and can be left to the courts to determine, based on the facts of a particular case.

However, the experience of a number of other countries also suggests that if litigation against outside directors is a significant risk, then outside directors will be reluctant to serve. The ratio of reward (the modest compensation that is customarily paid) to risk (the potential for being found liable for very large damages) will simply be unacceptable.

Russia does not face this situation at the present time. Thus, we make no recommendations. Still, it may be worthwhile to discuss possible approaches, which may be worth considering in the future. There are several possible ways to address directors' concern about liability for decisions adopted in good faith. One is through a different standard of liability for outside directors, when the issue is only one of reasonableness and not good faith. For example outside directors who adopt a decision in a situation that does not involve a conflict of interest, either for the directors or for other directors, senior managers, or the controlling shareholder, could benefit from a presumption of reasonableness (see Subch. 1.3 for a recommendation on this issue), and could also be protected against liability unless the

plaintiff shows that they acted with gross negligence, rather than simple negligence.

A second possibility is to limit the amount of monetary liability that outside directors face if they adopt decisions in a situation not involving a conflict of interest. For example, the United States allows companies to adopt charter provisions which eliminate *all* monetary liability of outside directors for breach of the duty of care. Japan allows a company to limit the liability of outside directors to twice their annual compensation. As a practical matter, this is low enough so that no one will sue them.

The concerns underlying the limits on the liability of outside directors are that if outside directors face potentially very large liability for their actions, they may be reluctant to serve or may be reluctant to take business risks that could lead to future liability, and that if outside directors are paid enough to overcome a reluctance to serve, the pay itself could be sufficient to compromise their independence.[218]

Duty of loyalty / good faith

This duty is applied to different persons in the comparison countries. For a controlling shareholder, the duty of good faith, in countries where it exists, is limited to transactions for which the controlling shareholder has a conflict of interest. But once the duty applies, it is the same for all persons subject to it in all of the comparison countries. We recommend that there should be a uniform duty of good faith, which should apply to directors, senior managers, and controlling shareholders.

Duty of disclosure

We recommend that the duty of disclosure should be phrased uniformly for all persons to whom it applies. As a practical matter, the duty of disclosure, like the duty of care

[218] *See* Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability: A Policy Analysis*, 162 J. INST'L & THEORETICAL ECON. 5 (2006), *available at* http://ssrn.com/abstract=878135.

or reasonableness, will be stricter for persons whose positions provide them with greater information about the company, and with a more central role in approving the company's disclosures.

Government-appointed directors

The duty of reasonableness contains two parts—a duty to become informed, and a duty to act reasonably once informed, though with a presumption that a director who is informed and acts without a conflict of interest has also acted reasonably. See Subch. 1.3. A government-appointed director should face the same obligation to become adequately informed. The government-appointed director should face the same duty of good faith, which can be violated by acting with a conflict of interest. The government-appointed director should face the same duty of disclosure.

However, there are two respects in which a government-appointed director, who under Russian law is required to vote in accordance with the written instructions of his superiors, should be excused from full compliance with the duties faced by other directors. The first is that a director who acts in accordance with written instructions from his superiors within the government should not be liable for a foolish decision, even if the decision is unreasonable. Perhaps the government should be liable instead, though that is a topic beyond the scope of this Report. The liability of a government-appointed director who does not comply with the instructions of his superiors is not a question of company law and is similarly beyond the scope of this Report.

Second, we recommend that a government-appointed director who acts in accordance with written instructions from his superiors within the government should not be liable for a decision that is contrary to the interests of the company.

A government-appointed director should benefit from these exemptions only for matters on which he acts in accordance with written instructions, and should be required

to prove that he did not solicit the instructions from his superiors in order to insulate a decision that was, in fact, his to make or to recommend to his superiors. That is, the protection should be limited to cases where the director was required by the nature of his position to act unreasonably or against the company's interests, not where he chose to do so.

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GLOSSARY OF SPECIALIZED TERMS

assistant general manager	French term, used to refer to a small number of senior managers who are subordinate to the general managers (CEO).
CEO	Chief Executive Officer (also known as the general manager or the general director).
controlling shareholder	Person who, together with his affiliated persons, directly or indirectly holds or controls the voting of 30% or more of the company's voting shares, so that this shareholder may, as a practical matter, be able to control the composition of the board of directors and the major decisions adopted by the company.
corporate governance	An overall system for governing the management and control of a company, including its organizational structure, business policy principles, guidelines, and internal and external regulation and monitoring mechanisms.
derivative suit	A suit brought by a shareholder in the name of the company, including a suit against a member of the company's management organs, or a controlling shareholder for breach of duty to the company.
executive director	A member of the board of directors who also holds a position as a manager of the company or an affiliated company.
executive organ	A company may have either an individual or a collegial executive organ.
independent director	A non-executive director who meets the standards for independence specified in the JSC Law.

inside director	Same meaning as executive director.
management board	Collegial executive organ of a joint-stock company.
management organs	Board of directors and executive organ.
manager	A senior executive of a company, including the members of the management board for a company with a management board.
non-executive director	A member of the board of directors who does not hold another position with the company or an affiliated company.
non-public company	A company whose common shares are not publicly traded on the open market.
officer	This concept is used in common law countries to refer to the senior executives of a company. Officers have the same duties to the company as directors. The courts determine whether a person is an officer based on the person's activities, not the person's formal title or formal authority.
outside director	Same meaning as non-executive director.
public company	A company which has issued common shares to the public. Includes all companies whose shares are actively traded, including companies whose shares are not "listed" on a securities exchange.
supervisory board	In a two-tier board system, as in Germany, the upper board is called the supervisory board. A principal duty of the supervisory board is to appoint the members of the management board.