SQUIRE SANDERS

RUSSIAN DIRECTOR LIABILITY: MEANINGFUL STEPS TOWARD A WORKABLE FIDUCIARY DUTY STANDARD

On August 20 2013, the Supreme Arbitrazh (Commercial) Court of the Russian Federation (the "**SAC**") issued Resolution of Plenary Session No. 62 "On Certain Matters of Compensation of Losses by Members of a Company's Governing Bodies" dated 30 July 2013 (the "**Resolution**"). The Resolution represents a huge initial stride in clarifying the duties of officers and directors of Russian companies and could have a profound positive impact on corporate governance practices of Russian commercial organizations as a result of providing a more coherent roadmap for guiding conduct and pursuing civil relief against officers and directors who act in violation of their fiduciary duties to the companies they serve.

The Standard

Russian law has long provided that officers and directors must act "reasonably" and in the "best interests of the company" and that officers and directors may bear joint personal liability before the company (directly or derivatively) for losses (actual loss and/or lost profits) incurred by the company for "culpable" or "wrongful" actions or inactions. The terms, "culpable" or "wrongful", however, were not defined under the law nor was the duty to act "reasonably" and in the "best interests of the company" well developed. Notably the burden of proof lay with the party alleging the breach of duty.

Clarity and predictability in fiduciary duty standards applicable to company agents is a fundamental bedrock principal necessary for the development of a robust commercial market. On the one hand, the standards cannot be too restrictive so as to deter businesses from engaging in commercially reasonable risk taking necessary for growth and innovation. On the other hand, they cannot be too lax so as to permit a company's agents to abuse their positions to the detriment of the company they serve.

To date, the Russian system has done a poor job in balancing these competing interests, favouring an ineffective criminalization of conduct while at the same time failing to provide a workable civil mechanism to protect investors from self-dealing agents. The Resolution is a welcome step forward in providing a more functional civil framework to guide officers seeking to grow the businesses of company they serve while providing investors with a civil tool to police the conduct of their agents. Only time will tell if these principles will be applied in an even handed way necessary for the effective functioning of the markets and advancing Russia's goal of becoming a respected financial center, but the initial application of the Resolution is promising.

Directors and Officers Subject to the Standard

The Resolution clarifies that the following categories of persons may be held liable to a company for losses incurred as a result of bad faith actions: (a) CEOs: general directors, management companies, managers, directors of the unitary enterprise; (b) members of the collegial executive bodies: members of the board of directors (supervisory boards); (c) individuals who used to be the members of the company's governing bodies; (d) liquidators (members of the liquidation committee); and (e) external managers and receivers.

Bad Faith Conduct of Directors and Officers

The Resolution clearly provides bad faith may be found were a director or officer:

1. Acted despite a existence of a conflict of interest;
2. Conceded information or knowingly provided to the shareholders incorrect information on a transaction entered into by him;
3. Entered into a transaction without having obtained the requisite approvals as required by law or the company's charter;
4. Knew or should have known that the counterparty is "knowingly unable to perform its obligations"; and
5. Knew or should have known that the transaction was unfavorable for the company (e.g. sale of assets at a substantially undervalued price).

Unreasonable Conduct

The Resolution further emphasized that the director may be held liable for "unreasonable actions" even though he acts in good faith. According to the Resolution unreasonable conduct includes:

1. Failing to perform adequate due diligence;
2. Taking action notwithstanding known relevant information; and
3. Failing to comply with the company's internal procedures (e.g. sign off by accounting, legal, etc.).

Compliance with Law

The SAC made clear that a reasonable director shall procure that the company fulfills its public law obligations.[1] Therefore, if a company breaches its legal obligations due to director's bad faith and/or unreasonable actions or omissions which result in losses by the company, such losses may be recovered from the director. The company will be restricted from indemnifying director for his actions/omissions which result from the company's breach of its public law obligations.[2]

Choice of Counterparties and Employee Hiring

The SAC has also indicated that a director is required to put in place an effective management structure with the company. Thus more emphasis is given to director's default liability for selection of candidates, choice of counterparties in contracts and the company's agents unless otherwise is provided by company's internal documents and policies. The SAC has provided that it is possible to claim from director losses incurred by the company as a result of the director's bad faith or unreasonable conduct (omission) in the performance of his duties with respect to choosing/overseeing:

- The company's agents;
- Counterparties in private contracts (*a counterparty turned out to be dishonest*);
- The company's employees (*a director has hired an incompetent employee whose actions caused losses to the company*).

Three Key Procedural Aspects of the Resolution

1. ***Burden Shifting***. The SAC adopted a key procedural change that fundamentally modifies the playing field by providing that a court may shift the burden of proof on the director to prove why his conduct did not violate the standard of proof under certain circumstances, such as if the director refuses to provide any explanations or provides insufficient explanations for his actions typically when proof has been presented that the director acted in the face of a conflict of interest.

2. ***Proof of Damages***. In the past the courts dismissed claims in most cases on the basis that the claimant could not prove the exact amount of loss. Under the Resolution the SAC demonstrated a more nuanced and sophisticated approach to damages analysis. Moreover, the SAC clearly demonstrated an approach that focused on substance over form, which has not typically been the approach in past decisions.

3. ***Expansion of Standing to Pursue Losses***. The Resolution provides that a new shareholder or participant[3] has the right to claim damages from director who has acted in bad faith or unreasonably prior to the shareholders acquisition of shares. This decision is a little curious because while the duty runs to the company the new shareholder arguably was in a position to conduct due diligence and price the risk (assuming it was not fraudulently concealed). The limitations period for such claims is three years starting from the day when a new shareholder/participant's predecessor learned or should have learned about the director's misconduct. When the predecessor (the claimant) is the company itself the limitation period starts upon the day when the company could realistically have learned of the director's misconduct. Based on the foregoing, one would expect that officers and directors will increasingly insist on waivers of potential claims in connection with exit transactions.

Relief from Civil Liability to Pay Damages

The Resolution provides for a number of grounds any of which allows a director to be relieved from an obligation to pay damages:

- If a director has not gone beyond ordinary business risk;
- If a director proves that an unfavorable transaction:
  - was part of a series of transactions, as a result of which the company was expected to obtain gain; or
  - was made with the intention to avoid more adverse consequences for the company;
- If the losses have been duly recovered by means of another remedy (e.g. losses have been recovered from the wrongdoer (e.g. employee or counterparty) and other). The SAC has indicated that allowing claim for damages does not depend on whether a transaction, which caused damages, was or was not invalidated.

The SAC expressly provided that approval of director's actions by the company's management board or shareholders does not by itself release him from liability for bad faith and/or unreasonable conduct, which results in losses for the company. In addition the SAC has established that members of the management board may be relieved from civil liability if they voted against a decision that resulted in losses for the company or while acting in good faith, did not participate in the voting.

1 Company's public law obligations may include payment of taxes, payment of salaries to its employees, keeping book records, complying with license conditions and so forth.

2 Further restrictions are still considered by the Russian Parliament, Draft Bill No. 47538-6/2 introducing amendments to the Civil Code (article 53.1(5)) provides that *agreements to restrict or exclude director's liability are void.*

3 A person *who at the time of the director's actions (omission), which resulted in losses for the company or at the time the loss was incurred, was not a participant/shareholder of the company.* It is noteworthy that new shareholder/participant still has no right to file an action seeking to invalidate the director's transactions since such transaction could not have breached the claimant's interests at that time (Resolution of the SAC's Presidium No. 9688/05 dated December 06 2005 with regards to the case No. A40-29380/04-24-343 and Resolution of the SAC's Presidium No. 9736/03 dated December 02 2003 with regards to the case No. A35-4767/02-C11).

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