ANNEX

to

STUDY ON DIRECTORS' DUTIES AND LIABILITY

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DIRECTORS' DUTIES AND LIABILITY IN AUSTRIA

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1 INTRODUCTION

1.1 Austria's regulatory regime

Austria is a civil law jurisdiction, thus the applicable law is primarily based on statutes.[1] The General Civil Code *(Allgemeines Bürgerliches Gesetzbuch)* sets out the general rules regarding property law and the law of obligations, including contract law and tort law. The initial source of company law has been the Commercial *Code (Handelsgesetzbuch)*, restated and renamed Business Enterprise Code *(Unternehmensgesetzbuch)* in 2006, which – to the extent it specifies, supplements or alters general provisions set out in the General Civil Code – is *lex specialis* in relation to the General Civil Code and, therefore, its applicability prevails in this relation. On the one hand it contains general provisions about companies, company names, the companies registers, asset deals, etc., but on the other hand it also sets out the special provisions for two forms of partnership, the general partnership *(Offene Gesellschaft; OG)*[2] and the limited partnership *(Kommanditgesellschaft; KG)*[3]. Special codes set out the legal framework for the public limited company, the Stock Corporation Act *(Aktiengesetz; AktG)*, and the private limited company, the Act on Limited Liability Companies *(GmbH-Gesetz; GmbH-G)*, respectively. These codes contain the key general provisions on directors' duties and liability, whereby such general provisions are – from a practical perspective – most notably further specified under Austrian accounting and insolvency law.

In addition, Supreme Court[4] rulings specify and enhance the general rules set out under statutory law. This is particularly relevant in the field of corporate law. In this respect, the Austrian Supreme Court is primarily guided by two determinants, namely (i) German jurisprudence, since Austrian company law still features quite strong similarities with German company law[5], and (ii) Austrian and German legal literature (regularly cited in judgments supporting and justifying the court's view)[6].

1.1.1 The private limited company

The Austrian private limited company *(Gesellschaft mit beschränkter Haftung,* short *GmbH)* is established by setting up a corporate statute (in the form of a notarial deed) to be filed with the Companies Register. Upon registration with the Companies Register, which *inter alia* requires the appointment of at least one director,[7] the limited private company is deemed incorporated. Its obligatory minimum registered capital amounts to 35,000 Euros[8] and, unless otherwise provided for, its members participate in the company relative to their interest in the company's registered share capital (i.e. relative to their investment). The private limited company is a legal entity. It has at least one shareholder (from a practical perspective the vast majority of private limited companies have no more than five shareholders). At least one director is to be appointed by the shareholder(s). The private limited company usually operates on a one-tier board structure, although the shareholders do

[1] Nevertheless, in particular in connection with the directors' liability it is case law that determines the duty and standard of care to be observed by directors.
[2] *Unternehmensgesetzbuch* (UGB), s. 105 - 160
[3] S. 160 – 177 UGB
[4] *Oberster Gerichtshof*, OGH

[6] And in this respect it is especially articles and commentaries, which are regularly cited in judgments.
[7] S. 2(1) and s. 3 GmbH-G
[8] S. 5 GmbH-G

have the possibility to establish a supervisory board, and in some cases – mainly due to the number of employees engaged by the company or its subsidiaries – they are obliged to do so[9]. The private limited company is prohibited from being listed on a stock exchange.

1.1.2 The public limited company

The public limited company *(Aktiengesellschaft,* short *AG)* is also incorporated by registration with the Companies Register requiring filing of the statute drawn up in the form of a notarial deed and subscription of all shares.[10] The public limited company is, likewise, a legal entity[11].

The company's capital is divided into shares (with or without par value) generally each conferring the same voting rights and entitlement to dividends, unless preference shares (*Vorzugsaktien*) are issued. A public limited company's minimum registered capital amounts to 70,000 Euros.

In the past, it has been common practice that Austrian public limited companies issue bearer shares rather than name shares. Following an initiative aiming at prevention of money laundering and terrorist financing, issuance of bearer shares shall only be permissible for listed companies.[12]

The company's bodies are the general meeting (*Hauptversammlung*), the executive board (*Vorstand*) and the (mandatory) supervisory board (*Aufsichtsrat* – which monitors the board of directors and is involved in strategic decisions).[13] The public limited company, as opposed to the private limited company, can be listed on the stock exchange. In case of a listing with the Vienna Stock Exchange, the Stock Exchange Act (*Börsegesetz*, *BörseG*) and the Capital Markets Code (*Kapitalmarktgesetz*, *KMG*) apply to listed public companies as well as the Corporate Governance Code.

1.2 Ownership structure of public companies in Austria

According to a study conducted in 2007 by the Federation of European Security Exchanges (FESE), Austria's "share ownership is significantly concentrated in domestic investors (equal or higher than 70%)"[14], the participation of private financial enterprises is extraordinarily high (33.7%, the UK is the only Member State with a higher participation of such enterprises at 44.7%, in all other Member States this percentage is below one third)[15] and also the participation of collective financial investors is above average (28.5%)[16]. Individual investors/households amount to only 7.3%[17] and the public sector holds 4.9%[18] of Austria's share capital. In total there are around 90 listed companies in Austria.[19]

[9] S. 29 GmbH-G
[10] Strasser in Jabornegg/Strasser (eds), *Aktiengesetz* (part two, 5th edn, 2010), Vor §§ 70-85, para 1
[11] Jabornegg (n3), s. 1, para 34
[12] See for example the draft for a legislative act that will change the shares of non-listed public companies to name shares (*Namensaktien-Umstellungsgesetz*, NamUG).
[13] S. 23 AktG
[14] FESE (Federal European Securities Exchanges), *Share ownership structure in Europe* (December 2008), 12
[15] ibid 14
[16] ibid 15
[17] ibid 21
[18] ibid 23
[19] www.wienerborse.at/investors/listedcompanies

2 DIRECTORS OF A PUBLIC COMPANY

2.1 Members of the management board

The management board may have one or more members,[20] who are appointed by the supervisory board for a period of up to five years[21] and whose personal details (including name, date of birth and address) must be registered in the Companies Register[22]. Contrary to trade law, corporate law doesn't impose any requirements as to the qualifications upon directors. It doesn't explicitly require a director to have a domicile in Austria, the Austrian citizenship, or any expertise at all. However, assuming the position as a director without having the necessary knowledge, experience and other abilities required by this position does not limit or otherwise affect the objective standard of care to be observed by directors in general and, consequently, is likely to result in the director's liability for a negligent breach of its obligations.[23]

2.1.1 Eligibility

Only natural persons may be appointed directors of the management board.[24] In addition, members of the supervisory board cannot concurrently be members of the management board[25]. Where the supervisory board in its capacity of appointing the management board members does not comply with these restrictions, the appointment is void, both in relation to the company and to any third party.[26]

There exist a number of further restrictions as to the eligibility for membership to the management board, where non-compliance does not result in the nullity of the appointment, but merely in the illegality of such appointment. In these cases the supervisory board is under an obligation to remove the respective director, who until such removal – in particular vis-à-vis third parties – validly holds office. Such restrictions can, for instance, be found in the Incompatibility Code[27], which provides that the top administrative organs (like the federal president, the federal ministers, etc.) as well as mayors may not hold any offices as directors in public companies. Further, members of the Court of Auditors[28] may not be appointed as directors in a company that is subject to the Court's control. Further restrictions can be found in professional codes for some regulated professions.

[20] Only if the company is active in the credit institutions sector, there must be at least 2 directors because of the "four eyes principle", which means that there must be mutual control; Strasser (n17), para 5
[21] S. 75(1) AktG
[22] *Firmenbuch*
[23] ibid s. 77-84, para 98
[24] S. 75(2) AktG
[25] S. 90 AktG
[26] Strasser (n11), s. 75, 76, para 6
[27] *Unvereinbarkeitsgesetz.*
[28] *Rechnungshof.*

2.1.2 Other persons who are subject to the managers' liabilities

In addition to the formally appointed managers, substituting managers (see s. 85 AktG) and members of the supervisory board, who temporarily engage in management matters (see s. 90(2) AktG), are subject to the managers' duties.[29]

A topical issue – less so in connection with public limited companies, but more so with respect to private limited companies – is whether or not (and if so, under what circumstances) ***de facto* directors** are also subject to directors' duties. A *de facto* director is a person who is not formally appointed as director and, thus, not registered in the Companies Register as director but who, in fact, significantly influences the management of the company.[30] This person does not necessarily have to be a shareholder of the respective company[31], however, the most relevant case in practice is when the sole shareholder of a public limited company in fact manages the company, and the appointed director, in fact, only executes the directions received from the dominant shareholder.

De facto directors are not generally subject to the same duties as formally appointed directors, but the OGH has affirmed the liability of *de facto* directors under certain circumstances and in particular in two contexts: the liability for failure to file for insolvency[32] and the liability for a grossly negligent depletion of creditors' interests[33].

For instance, in its decision 8 Ob A 98/00w the OGH held that a bank, that was a member of a private limited company and had de-facto-control over it, was liable for its contribution to the private company's failing to file for insolvency. In this case the bank influenced the management of the company significantly and, therefore, was bound to apply the standard of care that is imposed upon a director.[34] However, since the bank negligently breached its duty of care and caused losses of the private limited company, the private limited company was granted a claim against the bank (in addition to its claim against its own formally appointed directors). Furthermore, a de-facto-director's personal liability has been affirmed in relation to the breach of the criminal law provision that prohibits directors from depleting creditors' satisfaction by decreasing the company's funds when it is already insolvent.[35] In this case, *de facto* directors face both civil and criminal liability.[36] A possible liability of de-facto directors is also accepted by the case law for the failure to pay the due contributions for social security.[37]

To sum up, the concept of *de facto* directors is acknowledged in Austria, however, to what duties exactly *de facto* directors can be subject is not entirely clear. The question of whether there is an Austrian equivalent to the German liability for destruction of the corporate entity[38] of an influential

[29] Adensamer/Eckert in Susanne Kalss (ed), *Vorstandshaftung in fünfzehn europäischen Ländern* (Linde, 1st ed., 2005), 196
[30] RIS-Justiz RS0119794;
[31] OGH 2 Ob 238/09b; 8 Ob 124/07d; 8 Ob 108/08
[32] RIS-Justiz RS0123113; OGH 8 Ob 124/07d; 8 Ob 108/08b
[33] RIS-Justiz RS0084661; RS0095015; RS0096108
[34] OGH 8 Ob A 98/00w
[35] *S. 159 StGB. RIS-Justiz RS0124517; RS0095015; OGH 8 Ob 108/08b; 13 Os 42/87*
[36] Wolfgang Brandstetter, 'Der "Strohmanngeschäftsführer" im Kridastrafrecht – zum Umfang strafrechtlicher Haftung von Geschäftsführern und leitenden Angestellten' ecolex 1992, 244; Herbert Heiser, 'Haftung von Organen von Kapitalgesellschaften (Teil II) - Verbotene Einlagenrückgewähr, Verlust des halben Stammkapitals, Eigenkapitalersatz, Reorganisationsbedarf, Konkursantragspflicht' CFOaktuell 2010, 29, 33
[37] (See 5.1.2.3.2) RIS-Justiz RS0084661
[38] The so-called *Existenzvernichtungshaftung*.

shareholder who takes destructive decisions, for example, has not been answered authoritatively so far.[39]

2.2 Members of the supervisory board

The supervisory board must have at least three, but not more than twenty[40], members who are appointed by the shareholders[41]. In addition, for every two members appointed by the general meeting[42], the works council[43] appoints one employee representative as member of the supervisory board.[44]

According to case law the supervisory board as an organ (i.e. not every single member itself) must have more knowledge and experience in commercial and financial matters than the average business man would; they must be able to recognise complex legal and economical connections and to assess the consequences thereof for the company.[45] The individual supervisory board member must have the knowledge and experience necessary for exercising the supervisory board's duties competently.[46]

2.2.1 Prohibitions

According to s. 86(2) AktG a person can only be a member of a maximum of ten supervisory boards, whereby the position of chairman counts twice. For listed companies s. 86(4) provides for a maximum of eight supervisory board members. Furthermore, a legal representative of a subsidiary may not become a supervisor and also cross-over connections (see s. 86(2) number 3 AktG) are illegal. A member of the management board may also not become a member of the supervisory board (s. 90 AktG). The appointment of a legal person is also forbidden. However, the question of the consequences of an appointment contrary to these prohibitions (i.e. whether the relevant resolution/appointment is null and void or merely challengeable) is controversial.[47]

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[39] *See Hans-Georg Koppensteiner, 'Zur Haftung der Gesellschafter bei Zahlungsunfähigkeit der GmbH' JBl 2006, 681 and Ulrich Torggler, 'Fünf (Anti-)Thesen zum Haftungsdurchgriff' JBl 2006, 85*
[40] S. 86(1) AktG
[41] S. 87(1) AktG
[42] (or appointed as members of the supervisory board by the company statute)
[43] *Betriebsrat*
[44] If there is an odd number of corporate law directors the labour council appoints one employee representative for every two company law director plus one additional employee representative. This means that including the employee representatives, the supervisory board must have at least three corporate law directors plus two employee representatives, i.e. five members, and cannot have more than 20 corporate law members plus 10 employee representatives, i.e. 30 members in total. This concept is called the "one-third participation" (*Drittelbeteiligung*) or "one-third parity" (*Drittelparität*). See s. 110(1) Labour Relations Act (*Arbeitsverfassungsgesetz*, ArbVG)
[45] RIS-Justiz RS0049309; RS0116173
[46] RIS-Justiz RS0116168
[47] Strasser (n11), s. 86, para 18

3 DIRECTORS' DUTIES

Directors are fiduciaries, because they are managing someone else's (i.e. the company's) assets. Thus, they are both subject to a comprehensive duty of loyalty as well as a comprehensive duty of care regarding the execution of their functions.[48] They are bound to act in the company's interests (explicitly comprising the shareholders', employees' and public interests), not in their own or in the interests of the shareholders alone, and they – at least generally[49] – owe their duties to the company. Their duties arise with their appointment and generally end with their effective removal or resignation.

The main duties and liabilities of directors can be found in the AktG, however, several others originate from, in particular, insolvency law, tax law, social law, criminal law, competition law and administrative law.[50]

3.1 The management board

The Austrian AktG distinguishes provisions regarding the individual directors' duties from provisions regarding the duties of the management board as a whole (as an organ).[51] The relation between the different addressee's duties can broadly be described as follows: In performing the *board's* duties (see 3.1.1), the *individual* directors have to apply due care. *In addition*, they have to act loyally towards the company in general and comply with miscellaneous duties (see s. 3.1.2).

3.1.1 The board's duties

The board of directors is primarily obliged to manage the company (s. 70(1)), to represent the company in relation to third parties (s. 71(1)). In addition, the AktG regulates four special duties of the board: the duty to report to the supervisory board (s. 81)[52], the duty to maintain an accounting and monitoring system that is appropriate in respect of the company's size and business (s. 82), the duty to notify losses of the company to the shareholders (s. 83) and several duties regarding loans of the company to managers, certain employees and other persons (s. 80).[53] Furthermore, pursuant to prevailing doctrine, the management board is generally obliged to **act lawfully**. Therefore, it must act in accordance with the law, the company statute, the bylaws for the management board and its individual service contract. Further, it has to comply with any binding resolutions of a company organ.

[48] *Strasser (n11), s 77 – 84, para 67; Christoph Wolf, ‚Missbrauch von Insiderinformationen: Abberufung und Entlassung von Vorstandsmitgliedern' (2003) ecolex 2003, 741; Peter Jabornegg, ‚Die Lehre vom Durchgriff im Recht der Kapitalgesellschaften (Teil II) - Zurechnungs- und Haftungsfragen' (1989) WBl 1989, 43; Ulrich Torggler, 'Interessenkonflikte, insb bei "materiellen Insichgeschäften"' (2009) ecolex 2009, 920*

[49] Certain of the director's duties (in particular in connection with the company's accounting in the case of insolvency) are interpreted to (also) protect third party creditors of the company and, thus, their breach may result in the director's direct liability towards such third parties.

[50] For example the Insolvency Code (*Insolvenzordnung*, IO), the Federal Fiscal Code (*Bundesabgabenordnung*; BAO), the Unfair Competition Code (*Gesetz gegen den unlauteren Wettbewerb*, UWG) and the Criminal Code (Strafgesetzbuch, StGB) contain directors' duties, which can result in personal liability of the director in case of a breach.

[51] Strasser (n11), s. 77-84, para 1

[52] The board has the duty to provide the supervisory board with an annual report about future business strategies and about expected developments of the company regarding its financial situation and expected profits; in addition, they have to provide the supervisory board with a quarterly report about the actual situation of the company and the extent to which it coincides with the annual report.

[53] Other duties of the board foreseen in the AktG are for example that they have to examine the foundation of the company (s. 25(1) AktG) and register the company in the companies register (*Firmenbuch*; s. 28(1) AktG).

The latter may be a resolution of the supervisory board[54] or a shareholder resolution[55], if and to the extent such bodies are competent to resolve upon the relevant matter.[56]

S. 70(1) AktG empowers the management board to **manage the company** under its own discretion and responsibility and obliges the managers to do so in a way that the wellbeing of the company requires, taking into consideration the shareholders', the employees' and the public interests.[57] Three conclusions can be drawn from this section: First, in exercising their duties, the managers must act primarily in the best interest of the company as such, but they must also take into account the interests of shareholders and employees, and the public interest. The company's interest is primarily dependent on the company's corporate purpose set out in its statute[58]. Creditors are not mentioned as another interest group to be considered, but because of the numerous creditor protection rules of the AktG, it is assumed that the creditors' interests must also be taken into account.[59] To sum up, Austria's directors have to take a stakeholder oriented approach in managing the company and in its effort to advance the company's wellbeing, the individual directors must act with the due care according to s. 84 AktG. Second, the managers' power derives from statute and not from the shareholders. Therefore, in general the directors owe their duties only to the company (not to the shareholders) and, as a further consequence, the shareholders do not have a general instruction right towards the managers. Third, the managers of a public company are independent in the sense that they are not bound to any orders of other organs within the company, as well as from outside the company (for example from other group members).[60] Limitations to the directors' discretion in managing the company – but not exceptions to this rule – are all such matters that either require prior approval by the supervisory board (i.e. the measures listed in s. 95(5) AktG) or an affirmative resolution by the general assembly (in particular capital and restructuring measures). In such cases measures cannot be implemented against the management's will, however, the management board's power to exclusively determine the company's conduct of business is restricted.

3.1.2 The individual director's duties

The AktG contains three explicit duties of individual directors: The duty of non-competition (s. 79), the duty of confidentiality (s. 84(1) last sentence) and the duty of care (s. 84). The duty not to compete and to keep business secrets confidential can be qualified as specification to each director's comprehensive duty of loyalty[61], which fronts the duty of care. In general, all directors are subject to a duty to act lawfully and in the best interests of the company.[62]

3.1.2.1 Duty of care (s 84 AktG)

All management directors have to apply the care of a diligent and conscientious business leader when managing the company[63] with respect to both their relationship to the company and their relationship

[54] S. 95 AktG
[55] S. 103(1) AktG
[56] In particular, neither the supervisory board nor the general assembly are entitled to serve instructions.
[57] 70(1) AktG
[58] S. 17(1) AktG; Torggler (n52), 920
[59] Rudolf Strasser, 'Die Leitung der Aktiengesellschaft (Teil I)', JBl 1990, 447
[60] Therefore, they are not employees and don't have an employment contract with the company, but a "service contract" (Anstellungsvertrag). Strasser (n11), s. 75, 76, para 63
[61] ibid, s. 77 - 84, para 67
[62] See 3.1.1
[63] S. 84(1) AktG: "Die Vorstandsmitglieder haben bei ihrer Geschäftsführung die Sorgfalt eines ordentlichen und gewissenhaften Geschäftsleiters anzuwenden."

towards third parties.[64] The standard of diligence and conscientiousness is an objective standard determined – on a case-by-case basis – by the kind of company (i.e. the size, capital, business, economic situation, competitive circumstances, etc. of the company).[65] Thus, the relevant benchmark of compliance is an objective one in the sense that it is not dependent on the director's individual abilities[66], and a relative one in the sense that it depends on the specific company.[67] Both directors' actions as well as their omissions must comply with this standard. The duty of care also implies a duty to install adequate structures and control mechanisms within the company and the board.[68] The duty of care also includes a duty of the managers to monitor each other to a certain extent (in particular in case of allocation of duties between the board members), whereby the chairman of the management board has an increased duty to do so.

3.1.2.2 Duty of loyalty

All directors are subject to a duty of loyalty towards the company because they administrate and exercise power over the company's capital and, therefore, act as fiduciaries.[69] They are also bound to act in the best interest of the company rather than in their own interest. In general, directors have to avoid conflicts between the company's interests and their own, and if a conflict arises, they have to disclose it to the other members of the management board as well as to the supervisory board.[70] The exact boundaries of the duty of loyalty are indeterminable and, therefore, the legislator decided to explicitly regulate two important aspects of the duty of loyalty, namely the duty not to compete with the company and the duty of confidentiality.[71] Another problem explicitly addressed by the AktG is self-dealing, which is solved by approval mechanisms (in effect, approval by the supervisory board is necessary); however, the concept of self dealing is very limited as it only applies to contracts entered into directly with the board members, but not to cases in which the conflict of interest arises in transactions entered into with third parties). There is no statutory provision that deals directly with a managers' appropriation of corporate opportunities, however, this problem can be solved by virtue of the general duty of loyalty.

3.1.2.2.1 Non-competition (s 79)

S. 79 AktG is a non-competition provision, which contains three specific prohibitions: Members of the management board may not operate another business (this includes being a manager of another company[72]), they may not be a member of another company's supervisory board (except when this other company is part of the same company group or when the company has an equitable interest according to s. 228(1) UGB[73] in the other company),[74] and they may not be a personally liable partner of another company. These prohibitions mean to prevent a situation in the first place where a director

[64] Strasser (n11), s 77-84, para 95
[65] RIS-Justiz RS0116167
[66] Note that there are no specific requirements as to the qualifications of a director, however, if a person assumes the position of a director without the necessary knowledge and/or experience, he is liable for the negligent assumption of this position. See 2.1.
[67] Herbert Heiser, 'Haftung von Organen von Kapitalgesellschaften (Teil I) - Allgemeines, Abgabenzahlungspflicht, Haftung für Ertrag- und Umsatzsteuern sowie Sozialversicherungsbeiträge' CFOaktuell 2009, 264, 265; Adensamer/Eckert (n32), 174
[68] Adensamer/Eckert (n32) 179-180; an explicit implementation of this principle is s. 82 AktG, which provides for a duty of the management board to maintain an accounting and monitoring system that is appropriate in respect of the company.
[69] For a detailed discussion of the duty of loyalty in corporate law in Austria, Germany and Switzerland, see Michael Becker, 'Treuepflichten im Körperschaftsrecht' ÖJZ 1999, 794.
[70] Torggler (n52), 921; Adensamer/Eckert (n32), 182
[71] Strasser (n11), s. 77-84, para 67
[72] ibid para 73
[73] According to s. 228(1) UGB a company has an equitable interest in another company if the company holds an interest in the other company, which is meant to establish a durable business relationship between the two, which is assumed in case a 20 % interest is held. It is irrelevant in this respect whether or not this interest is incorporated in any securities. (…)
[74] This prohibition includes any position within a one-tier board, like it is possible in an SE (societé européenne).

could find himself in a position of real competition and, thus, in a conflict of interest.[75] In addition, s. 79 contains a "real competition prohibition": Members of the management board may not deal within the company's field of business, irrespective of whether they act for their own account or for a third party's account. Acting for a third party's account includes, for example, the position in an organ or acting as an employee.[76] However, the supervisory board is competent to authorise such competing activities of managers and also to revoke their approval again. S. 79 may be ceded either by way of a respective clause in the director's contract (to be concluded between the manager and the supervisory board) or by a supervisory board resolution, but not in the company's articles (i.e. through a shareholder resolution) because s. 79 specifically empowers only the supervisory board to give their consent to competing actions of management board members.[77]

The duty not to compete – contrary to its confidentiality obligations – usually ends when the director ceases to be a director, except when the director's contract contains a non-competition clause.

3.1.2.2.2 Corporate opportunities

An important implication of the duty of loyalty is that directors may not exploit the company's business opportunities for themselves. To the extent that such a case doesn't fall within the explicit prohibition to compete with the company (see above), it can still be forbidden on the grounds of the general duty of loyalty. For example, directors may not interfere with the business relations of the company and they may not assume business opportunities in the company's field of operation that they have learned about through their position as directors to the disadvantage of the company.[78] The problem of the assumption of corporate opportunities can be solved *per analogiam* to s. 79 AktG (prohibition to compete with the company). Thus, a director may only use a corporate opportunity if the supervisory board gives its consent thereto.[79] If it doesn't, the company can chose whether it enforces any claims of damages against the director or whether it takes over the deals the director has concluded instead (or the benefits derived therefrom, respectively).[80]

3.1.2.2.3 Self-dealing

A director may engage in deals where he is party on both sides – i.e. where he acts for himself and as a representative of the company – only with ex ante or ex post consent of the shareholder meeting or of the supervisory board. The supervisory board is generally competent to represent the company when it deals with members of the management board.[81] The shareholders may give their consent either when they have been asked to do so (s. 103(2) AktG) or by way of amending the articles. The management board as an organ may also approve such self-dealing as long as the conflicted manager doesn't take part in the decision. The failure to obtain any of these approvals constitutes a breach of the directors' duty of loyalty, except when the deal was in the exclusive interest of the company.[82] In this respect, note s. 80 AktG, provides that the company may only give credit to a manager (or to his spouse or minor child) with the supervisory board's consent.

[75] Strasser (n11), s. 77-84, para 73
[76] ibid, para 76
[77] ibid, para 70
[78] Torggler (n52), 921
[79] Adensamer/Eckert (n32), 182
[80] Strasser (n11), s. 77-84, para 79
[81] *S. 97(1) AktG; Johannes Reich-Rohrwig, 'Wann vertritt der Aufsichtsrat die Aktiengesellschaft gegenüber Vorstandsmitgliedern?' WBl 1987, 299*
[82] Strasser (n11), s. 77-84, para 10

3.1.2.2.4 Confidentiality (s 84(1) last sentence)

The code provides that managers are bound to secrecy in respect of confidential information[83], but according to case law this duty to confidentiality is a general one and, therefore, includes all kinds of “business secrets”. “Business secrets” are all information that was only given to the managers and the supervisory board, or only to certain persons who are bound to secrecy and that is accessible only with difficulty to other persons. In addition, the company must have an objective interest in keeping this information secret.[84] Directors are exempt from this duty only if it is unreasonable for them to be bound to it, for example in the case of a litigation between the director and the company.[85]

For the individual director the duty of confidentiality arises whenever he or she knew or must have reasonably known the confidential character of the information received; in this respect it doesn’t matter how the director received the information. On the other hand, management board members have the duty to inform one another and also supervisory board members of anything that these directors ought to know in respect of their function within the company.[86]

The duty of confidentiality depends on the position as a director and, thus, would actually have to end with the termination of this position, but most of the Austrian (and German) literature advocates the extension of this duty to when the director has ceased his position because of the function of this duty (i.e. because of the economic need of confidentiality).[87]

3.2 The supervisory board

In exercising its duties the supervisory board is bound to the same objectives as the management board: Primarily, they have to act for the wellbeing of the company, while taking into account shareholders’, employees’, creditors’ and the public interest.[88]

3.2.1 The board’s duties

In general, the supervisory board has to supervise the management board’s activities (s. 95 AktG) and in certain (limited) cases they have to represent the company (s. 97 AktG).

Their **duty to supervise** extends not only to formally appointed managers, but to all persons, who carry out management functions. The board has to assess whether management activities comply with the law and the company statute as well as whether they are economically sensible (or, in other words, if the management uses its discretion not only lawfully but also purposively).[89] In this respect the board can generally trust the information and reports they get from the managers, however, if there are evident insufficiencies (i.e. if there are insufficiencies to the managers’ information, which a person with the required qualifications should have noticed), the individual supervisory board member

[83] S. 84(1) sentence two AktG
[84] Strasser (n11), s 77-84, para 87
[85] ibid, para 94
[86] ibid, para 89
[87] ibid, para 91
[88] OGH 1 Ob 144/01k; 7 Ob 58/08t
[89] RIS-Justiz RS0049302

has a duty to inquire further.[90] In any event, the supervisory board may investigate the company's activities by examining the company's books and records and its actual activities[91], and may always require a report of the managers about the company's relation (also regarding their relations within a group)[92]. If the supervisory board finds any insufficiencies in the management activities, they have to inform the management board of their findings and take the appropriate measures (for example, the removal of managers). A breach of any of these duties (including the failure to exercise the competences granted to the board under the AktG appropriately) may lead to the supervisory board members' liability.[93]

S. 95(5) AktG contains an exclusive list of matters that require the supervisory board's prior approval. As usual, in making a decision the directors have to act in the interest of the company and its stakeholders, and act with due care.

According to s. 97 AktG, the supervisory board has to **represent the company** when it concludes contracts with directors, when the general meeting resolved to litigate claims against the directors, and when litigation of such claims is mandatory even without or contrary to a shareholder resolution.

3.2.2 The individual director's duties

3.2.2.1 Duty of care

According to s. 99 and s. 84 AktG all members of the supervisory board are subject to the same duty of care (and to the same applicable objective standard in this respect) as the managers (see above). This means that they have to apply the care that can reasonably be expected from them in performing their functions. In this respect the OGH ruled that the supervisory board (as an organ) must have more knowledge and experience in commercial and financial matters than the average business man would, that they must be able to recognise complex legal and economical connections and to assess the consequences thereof for the company. Therefore, the applicable standard of care is an objective one and the supervisory board members cannot rebut their liability by proving their lack of personal knowledge or experience.[94] Their control and monitoring must extend to all significant management activities and they must react to their findings with appropriate measures.[95]

3.2.2.2 Duty of loyalty

The members of the supervisory board are bound to act in the interest of the company (not in their own) and since s. 99 AktG explicitly refers to s. 84 AktG (a rule generally applicable to management

[90] Strasser (n11), s. 95-97, para 11
[91] See s. 95(3) AktG;
[92] See s. 95(2) AktG
[93] Further, the supervisory board has to call a general meeting if the wellbeing of the company so requires (s. 95(4) AktG). This means that the board has discretion as regards this decision and must use this discretion with due care. The supervisory board as an organ has to assess the annual accounts, the proposed distribution of profits, the financial report and, if applicable, the corporate-governance-report and report to the general meeting about it within two months from when they received the respective documents (s. 96 AktG). The board has to fulfil this duty in spite of the auditor's examination of the annual report and the financial report (Strasser [n11], s. 95-97, para 55). The supervisory directors face criminal liability for incorrect statements in their report (s. 255 para 1 AktG; Strasser [n11], s. 95-97, para 53). The supervisory board members must examine the foundation of the company (s. 25(1) AktG), register the company in the companies register (*Firmenbuch*; s. 28(1) AktG) and to appoint the managers (s. 23(2) and 75(1) AktG).
[94] RIS-Justiz RS0049309; RS0116173
[95] Strasser (n11), s. 98-99, para 35

board members) as such, they are subject to the same duty of confidentiality as the managers (see 3.1.2.2.4). S. 79 AktG (the managers' duty not to compete), on the other hand, is not applicable to the members of the supervisory board.[96] Therefore, it can be said that the members of the supervisory board are subject to the same standard of care as the members of the management board and they also have to act in the best interest of the company, however, they are not subject to the same strict standard of loyalty. Since the position on a supervisory board is not a fulltime job and can vary in its intensity, the applicable standard of loyalty depends on the specific functions of the supervisory board member (as well as the economic situation the company is in).

[96] ibid, para 39

4 DIRECTORS' DUTIES IN THE VICINITY OF INSOLVENCY

Directors generally have a duty to act in the best interest of the company, which is usually characterised by a stakeholder approach. In the company's material insolvency, the directors' discretion to act is more restricted than usual because it is more focussed on creditors' interests.[97] This reasoning has two important consequences:

4.1 The duty to file for insolvency

According to s. 69(2) of the Insolvency Code when the company is illiquid or over-indebted, the managing directors of a public (and private) limited company must file for insolvency without undue delay and in any case within 60 days. Illiquidity[98] means that the company is unable to pay all of its due and payable obligations and will probably not be able to raise funds for payments in the near future. This definition is not found in the Insolvency Code but has been developed by the Supreme Court. Over-indebtedness[99] means that the company's liabilities exceed its assets and, in addition, the company is unlikely to be able to survive in the medium term.[100] Since all liabilities (irrespective of their due-date) are considered in this calculation, the insolvency case of over-indebtedness is usually reached at an earlier stage than illiquidity. According to the Supreme Court, the absolute limitation of 60 days starts running when the insolvency situation manifestly appears on the surface[101], however, in the literature there are several opinions about the start of this time period, including the point in time when a director knows of the insolvency and the point in time when the company actually becomes insolvent[102].

4.2 The duty to stop making payments

After the company has become materially insolvent – i.e. over-indebted or illiquid – the directors may generally not take any measures, which affect the insolvency estate.[103] Inter alia if such payments have been made after the company has become materially insolvent and not longer than 6 months before the insolvency proceedings have been opened, they are voidable according to insolvency law.[104] However, payments consistent with the care of a diligent businessman are allowed, for example payments for deliveries that are essential to preserve the value of the company like payments for employees' wages. But even these payments are allowed only within 60 days of the

[97] Adensamer/Eckert [n32] 177-178.
[98] S. 66 IO
[99] S. 67 IO
[100] RIS-Justiz RS0064886; Note that this insolvency case is only valid for legal persons (and some other forms of companies) because of creditor protection considerations (s. 67 IO; Adensamer/Eckert (n32), 250-252).
[101] OGH 15 Os 120/90
[102] See Adensamer/Eckert (n32), FN 471
[103] This duty arises from s. 84(3) para 6 AktG. RIS-Justiz RS0095715; Strasser (n11), s. 77 – 84, para 133. For the supervisory board this provision means, for example, that they may not approve of any deals according to s. 95(5) AktG, which would lessen the insolvency estate.
[104] S. 30 (preferential treatment of certain creditors) and 31 (making payments despite knowing of the insolvency) IO; OGH 6 Ob 37/01m; Strasser (n11), s. 77 – 84, para 133.

company's insolvency because then (at the very latest) the directors must file for insolvency and may not make any payments to creditors anymore.

5 LIABILITIES

5.1 The executive directors

The executive directors' liability towards the company is regulated in s. 84 AktG; their liability towards third parties can arise from general tort law. Therefore, a director can be liable towards the company and towards third parties at the same time, if it breaches s. 84 AktG and a statutory provisions aiming at the protection of third parties at the same time.[105] In addition to the director's liability for damages it caused to a third party, the company is also always liable towards the third party for the director's behaviour since all tortious behaviour that the director has applied during performance of its function as a director is attributable to the company. However, if the third party enforces its claim against the company, the company is entitled to recover its loss from the director.[106]

Generally, the members of the management board are jointly and severally liable for the board's actions, however, if the board reached its decision by a majority resolution, only those members of the board, who voted in favour of the proposal, are liable, if the dissenting members took all actions reasonably to be expected by such member to prevent the damaging measure from being implemented.[107] Consequently, if the board is structured in a way where different divisions are responsible for different issues, only the members of the division can be liable, in whose responsibility the respective issue fell, unless the other members failed to observe their monitoring obligations.[108]

5.1.1 Liability in relation to the company (s. 84(2) AktG)

In general the board may be held liable for breaches of duties owed to the company, which seek to protect the company and in particular the company's capital.[109] The main norm of directors' liability is s. 84 AktG, which contains the duty of care and confidentiality in paragraph one and the regime on directors' liabilities in relation to the company in paragraphs two to six, whereas s. 84(3) AktG contains special cases of liability. Furthermore, the directors' liability according to s. 84(2) AktG can be the consequence of any breach of duty owed by the director to the company, not only of a breach of s. 84(1) (the duty of care or confidentiality).[110] General conditions for a claim against directors include:

a. A **loss**, i.e. a negative effect on in the company's value. The loss is determined by subtracting the actual value of the company from the hypothetical funds that the company would have without the (damaging) measure in question.
b. **Causation**, i.e. the director's behaviour was necessary precondition *("conditio sine qua non")* for the loss or, in other words, the loss wouldn't have occurred if it weren't for the director's (passive or active) behaviour. In certain cases different tests (other than *conditio sine qua non*) are applied to determine causation, if the *conditio sine qua non* test is not capable of addressing the issue at hand (e.g. alternative causation by two directors).

[105] Strasser (n11), s. 77-84, para 101
[106] ibid, para 102
[107] In addition, the managers who abstained from voting are also liable. Strasser (n11), s. 77-84, para 104 and 105
[108] Except where the delegation of the responsibility to a division was negligent in the first place or where the other managers failed to monitor the division appropriately. Further, an "informal" structure of the board that was only decided internally (only within the management board) does not have the mentioned effects.
[109] Adensamer/Eckert (n32), 167
[110] Strasser (n11), s. 77-84, para 98

c. **Illegality**, i.e. a breach of any of the director's duties towards the company. This could be a breach of the duty of care, the duty of loyalty, or any other duty imposed by the law, the company statute or a binding resolution of a company organ.[111]
d. **Fault:** The director's liability is usually deployed by a negligent conduct of the director,[112] which also means that directors can only be liable for their own behaviour[113].[114] Negligence is defined as a deviation of the necessary care[115] but without being grossly negligent; gross negligence is a conspicuous carelessness or extreme deviation from the necessary standard of care.[116]

According to s. 349 Commercial Code[117] the directors' liability according to s. 84 AktG extends not only to the company's loss but also to its lost profit.[118]

5.1.1.1 Examples of breaches of duties

A manager is in breach of his duties, for example, if he doesn't act within his competence or if he acts without the necessary approval of other managers, the supervisory board, or of the general meeting (for example, if he fails to obtain approval of a self-dealing transaction). However, if such consent is obtained ex post, the respective breach of duty (as opposed to the company) is remedied.[119] Non-compliance with the duty of confidentiality, the appropriation of corporate opportunities, the failure to provide the required reports, the negligent examination of the company's foundation, etc. may all lead to the directors' liability, if the necessary preconditions are (not) fulfilled. Any case where a director failed to monitor delegates or where the delegation of responsibilities itself was negligent, or cases where responsibilities weren't delegated but assigned to a specific person or division and the assignment itself was negligent, may also lead to the directors being liable to the company.

5.1.1.2 Special cases of liability in s. 84(3)

S. 84(3) AktG explicitly mentions certain cases of managers' liability, namely illegal 1. repayment of the shareholders' investment[120]; 2. payment of interest or illegal distribution of profits to the shareholders; 3. repurchase of or creation of any interest in the company's own shares; 4. issuing of shares before their nominal value has been received by the company; 5. distribution of the company's capital; 6. making payments after the company has become over-indebted or illiquid;[121] 7. granting

[111] ibid, para 171
[112] RIS-Justiz RS0049459, 1 Ob 179/73; merely s. 84(5) requires gross negligence: S. 84(5) provides that creditors may only hold managers liable for their loss if they cannot be satisfied by the company and if the managers have comported themselves grossly negligent. However, liabilities according to s. 84(3) are exempt from this requirement, i.e. in these cases negligence suffices for the creditors to be able to hold the managers liable.
[113] Therefore, if a director delegated (some of) his responsibilities, he can no longer be held liable in this respect, but only the delegate. However, the duty of care also implies a duty to install adequate structures and control mechanisms within the company and the board and, therefore, the delegating director can still be liable for failing to properly monitor the activities of the delegate. Furthermore, liability may result from a per se negligent delegation (Adensamer/Eckert (n32), 179-180). In these two cases, the delegating directors are severally and jointly liable for their negligent comportment (ibid 181).
[114] The assessment of the directors' fault at this late stage is rather insignificant, since in most cases already the illegality of the directors' actions presupposes negligence (for instance a breach of the duty of care already implies negligence). The fact that the managers' liability is still assessed according to the mentioned four prerequisites (i.e. loss, causation, illegality and fault) is due to this conception having its foundations in general tort law.
[115] S. 1332 ABGB
[116] Reischauer in Rummel (ed), *ABGB* (2004), s. 1324, para 3 and 8
[117] *Unternehmensgesetzbuch* (UGB), s 349
[118] S. 349 UGB: "Between businessmen the compensable loss also comprises the lost profit."
[119] Adensamer/Eckert (n32), 184
[120] *Einlagenrückgewähr*
[121] See 5.1.1.4.3

credit; and 8. distribution of shares before the nominal value has been received by the company in respect of a conditional share issuance[122].

Generally, any payments to shareholders (unless under transactions entered into on arm's length terms) other than in course of a distribution of the balance-sheet profits shown in the approved annual accounts, a formal reduction of the company's stated share capital or the distribution of the liquidation surplus after the liquidation of the company will lead to the managers' liability because it will be qualified as a forbidden repayment of the company's capital. The same is true for deals with the managers that would not have been concluded in the same way with a third party (for example, where the company pays a price to the manager that is much higher than the price that would have been paid to a third party).[123]

The managers' liability in these cases is, as mentioned above, equally subject to the general preconditions for their liability (i.e. a loss, causation, illegality and fault). However, in these cases a loss is being legally presumed[124] and, consequently, the burden of proof shifts to the manager, who has to prove that the company has not suffered any loss from his misconduct. Where a director breaches his duty not to compete, the company may either claim damages or take over the contracts and transactions illegally concluded by the director.[125]

5.1.1.3 Liability according to s. 100 AktG

S. 100(1) AktG provides for a liability of a person who induces (with intent) a member of the management or supervisory board to harm the company in order to incur an advantage for himself or any other person. However, the acting director is also liable for his breach of duty in this respect according to s. 84 AktG or (in the case of a supervisory board member) s. 99 AktG.

5.1.1.4 Liability in the vicinity of insolvency

5.1.1.4.1 Liability because of failure to file for a reorganisation procedure

The Company Reorganisation Code (URG)[126] provides for a possibility to apply for a reorganisation procedure when a company is not yet insolvent but in need of reorganisation[127]. As opposed to insolvency proceedings, the reorganisation procedure is not mandatory. However, s. 22 URG imposes a liability towards the company on directors (managers as well as supervisory board members) in two cases: First, if the auditor's report on the annual accounts indicates a need for reorganisation but the directors don't apply for a procedure and within two years the company files for insolvency; and, second, if the annual accounts have not been produced in a timely manner or if no auditor has been appointed to revise the annual accounts. Directors are exempt from their liability if they mandated an accountant who negated the need for reorganisation[128] or if they can prove that the failure to apply for

[122] *Bedingte Kapitalerhöhung*
[123] *For a detailed discussion see Heiser (n39).*
[124] Adensamer/Eckert (n32), 192
[125] S. 79(2) AktG
[126] *Unternehmensreorganisationsgesetz* (URG)
[127] The URG doesn't provide for a definition of the need of reorganisation, but only mentions an example for it, namely when a significant and sustainable decrease of the company's own funds ratio is determinable. See s. 1(3) URG.
[128] See s. 26 URG

reorganisation didn't cause the insolvency[129]. The directors are liable for all obligations not defrayed by the insolvency procedure but their liability is limited to 100,000 Euros per person.[130] However, if the directors breached the duty of care by not applying for reorganisation, they may face unlimited liability according to s. 84 AktG.[131] The directors are jointly and severally liable.[132]

5.1.1.4.2 Liability for payments made after the company has become over-indebted or illiquid (s. 84(3) para 6)

Further to the principles outlined above that after the company has become materially insolvent – i.e. over-indebted or illiquid – the directors may generally not take any measures, which affect the insolvency estate: They breach this duty if they, for example, make payments or grant security for liabilities incurred before the company's insolvency or if they incur new liabilities. They can also be in breach of their duties if they don't cancel orders that they won't be able to pay for.[133] A breach of this provision leads to the director's liability towards the company (which can be enforced either by the company or – after insolvency proceedings have been commenced – by the insolvency administrator).[134] However, according to case law the director's liability is subsidiary to the company's claim against the recipient of the unlawful payment.[135]

5.1.1.5 Review of directors' business decisions

The application of the duty of care concerns the directors' decision finding process, not the decision and, in particular, its consequences itself. This means that the directors must apply the care of a diligent and conscientious business man in reaching a decision (i.e. in using their discretion), but whether the business decision was good or bad (in hindsight) does not determine whether or not the directors complied with their duty of care.[136] Therefore, risky deals are not negligent, as long as at the time of their conclusion it was possible or likely that they would prove advantageous for the company.[137] This is because the Supreme Court holds that holding directors liable for making a bad business decision contradicts the initial concept of the corporation that the risk of doing business must generally be borne by the company and not the individual directors.[138] This operation of the duty of care can either be justified with the fact that directors have discretion in taking business decisions and, thus, they are only in breach of their duties to the extent that they use their discretion without due care[139] or with reference to the business judgment rule[140]. To sum up, it can be said that the OGH recognises the extensive discretion of the managers and is reluctant to review their business decisions and even refers to the business judgment rule as such (without however explicitly applying

[129] See s. 27 URG
[130] Note that this liability presupposes neither illegality (since there is no duty to file for reorganisation) nor fault.
[131] Adensamer/Eckert (n32), 262
[132] Heiser (n39), 31
[133] However, they can make payments that a diligent business man would make even in this situation, see 4.2.
[134] Adensamer/Eckert (n32), 256
[135] OGH 9 ObA 416/97k
[136] OGH 1 Ob 144/01k
[137] RIS-Justiz RS0049458
[138] OGH 1 Ob 144/01k
[139] RIS-Justiz RS0049482; Adensamer/Eckert (n32), 172-173; Note, however, that in certain cases the aforementioned discretion either does not exist, or, like in the vicinity of insolvency, can be significantly restricted (Adensamer/Eckert [n32] 177-178). The prevailing view is that there is no discretion as regards the compliance with legal requirements (see Marcus Lutter, 'Die Business Judgment Rule in Deutschland und Österreich' GesRZ 2007, 79).
[140] See Lutter (n151), who argues that according to Austrian law the same criteria, which are preconditional to the application of the business judgment rule in Germany (and in the US), lead to the application of the Court's review only of the use of discretion.

it).[141] As a result, as long as the directors acted with due care in finding their decision, the (Supreme) Court will not review the consequences of the decision.

5.1.2 Liability to third parties

Since the directors do not have any direct (contractual) relation with third parties, the only possible basis for a direct claim of shareholders or creditors against the directors – aside from specific provisions of law[142] – is tort law. However, they are not entitled to hold a director liable simply because of a breach of his duties towards the company, but rather these outsiders can only raise a claim against a director if he breached a rule, which is specifically designed to protect such third party's interests. This is a general principle of tort law.[143] In any case immoral intentional damage[144], intentional delusion[145], and the breach of so called "protective rules"[146] will lead to the director's liability towards third parties.[147]

5.1.2.1 Cases of liability to the shareholders

Several norms oblige the issuer of securities to publish a **prospectus** with information about the issuance.[148] A breach of this duty may cause criminal liability according to s. 255(1) AktG and s. 15 KMG as well as tortious liability. Primarily, the company is liable, however, according to general civil law regarding the liability of legal representatives the directors may be held liable under certain additional circumstances, namely if they acted with intent and if they either pursued significant economic self-interests[149] or drew on an exceptional trust relationship[150] with the respective shareholders.[151] Note that this is a liability based on general civil law and, therefore, the shareholders' claims preclude within 3 years from the point in time when they have come to know (or should have known) the loss and the damaging person.[152] The loss the director is liable for includes not only the difference between the assumed value of the security and the actual value of the security but also the lost profit.[153]

According to s. 48d BörseG all issuers of listed securities must instantly publish any **insider information**, which directly concern the issuer, is unknown to the public and is able to significantly influence the market value of the issuer's securities. Under certain circumstances – set out in s. 48d(2)

[141] OGH 6 Ob 28/08y
[142] For example s. 9 BAO and s. 67(4) ASVG; see 5.1.2.3
[143] According to tort law the liability *ex delicto* differs from a liability *ex contractu* in the respect that the latter renders a person liable for any illegality, whereas the former presupposes the breach of a norm that was specifically designed to protect the party who suffered the loss.
[144] See s. 1295(2) ABGB
[145] See s. 874 ABGB
[146] *Schutzgesetze*
[147] Heiser, (n71), 264
[148] See s. 2 *Kapitalmarktgesetz* (KMG), s. 72 and s. 74 BörseG, s. 6 *Investmentfondsgesetz* (InvFG), s. 7 *Immobilien-Investmentfondsgesetz* (Immo-InvFG) and s. 7 *Übernahmegesetz* (ÜbG)
[149] A significant economic self-interested is given in a situation similar to where the director is actually acting on his own behalf; Adensamer/Eckert (n32), 248
[150] An exceptional trust relationship presupposes an extensive influence of the director or the lack of a possibility for the shareholder to survey the directors' statements; Wiebe in Kletecka/Schauer (eds), *ABGB-ON*, 1.00 s. 861, para 45; Adensamer/Eckert (n32), 247-248
[151] This is the so called "agency liability" (*Vertreterhaftung*): According to s. 1313a ABGB the principal is liable for damages that his agent caused. Therefore, usually, it is the company, not the director himself, who would be liable for the failure to publish a prospectus (see Reischauer (n119), s. 1313a, para 8b). However, the representative could exceptionally be held liable under the abovementioned conditions (Wiebe in Kletecka/Schauer (n163), 1.00 s. 861, para 45; Adensamer/Eckert [n23], 247).
[152] S. 1489 ABGB
[153] This is because the director's liability is (like the company's liability would be) a contractual, not a tortious liability; Adensamer/Eckert (n32), 230

– the issuer may delay the publication of the respective information. The issuer may face criminal liability according to s. 255(1) AktG as well as other sanctions and civil liability on the basis of tort law. However, the directors themselves might also face liability on the basis of general tort law, in particular according to s. 1295(2) ABGB (intentional immoral damage), s. 1300 ABGB (knowingly giving wrong advice), s. 874 ABGB (intentional delusion) and according to the protective rule of s. 255(1) para 1 AktG, which provides for criminal liability for directors who intentionally display the company's situation incorrectly in public reports. Furthermore, liability for failing to properly inform shareholders can arguably also be based on the general liability of legal representatives (see above), but only if the director(s) acted with intent and if they either pursued their own economic interests or drew on a personal trust relationship with the shareholders.

Directors of listed companies are obliged to disclose any self-dealings (**directors' dealings**) with certain securities (i.e. transactions that the respective director has effected with the company's securities), which equal to or more than 5,000 Euros in value, to the Financial Markets Supervisor[154] as well as to the company.[155] This rule is a protective rule in relation to the company as well as the security holders and, therefore, a director who is in breach of this duty is liable for any damages caused to the company and the respective security holders, including shareholders.

Importantly, so called "reflex damages"[156] – these are only "indirect damages" to the shareholders because they are actually damages to the company that are reflected in the share value – can generally not be claimed by the shareholders.[157]

5.1.2.2 Cases of liability to creditors

According to s. 83 AktG the management board must **call a general meeting** when half of the company's nominal capital has been lost. Whether this is a protective rule as regards the creditors, which is able to lead to tortious liability of the managers in relation to the creditors, is controversial[158].

According to general contract law, the parties have a **pre-contractual duty to provide the other party with the relevant information** in this respect. If an agent of the contractual party fails to properly elucidate the other party, it is not the agent who is liable but the contractual party; i.e. in principle, the directors may not be held liable directly by the creditors for failing to properly elucidate on behalf of the company. However, under the same conditions as applicable to the liability towards shareholders[159] – i.e. a special trust situation or significant economic self-interest of the director – directors may be held liable directly by the creditors and, as a result, the company as well as the directors are both liable to the creditors.[160]

Another noteworthy case of liability of directors towards creditors is the so called liability for the **delayed initiation of insolvency procedures**[161]. According to s. 69(2) of the Insolvency Code when

[154] *Finanzmarktaufsicht*, FMA
[155] See s. 48d(4) BörseG
[156] *Reflexschäden*
[157] OGH 1 Ob 128/07s; Heiser (n71), 264
[158] Heiser (n39), 30; Adensamer/Eckert (n32), 246 argue that a direct liability towards the creditors is contradictory to the wording of s. 83 AktG.
[159] See 5.1.2.1
[160] Adensamer/Eckert (n32), 247
[161] *Konkursverschleppungshaftung*

the company is illiquid[162] or over-indebted[163] the managing directors of a public (and private) limited company must file for insolvency without undue delay and in any case within 60 days. This rule is a protective rule in relation to the company as well as the creditors and, therefore, the managers who fail to comply with it may be held liable directly by any damaged creditors, despite the lack of a contractual relation. In such case, case law and literature distinguish between the different damages of creditors who already had a claim when the over-indebtedness/illiquidity arose (original creditors[164]) and creditors whose claim was created only after the material insolvency of the company (new creditors[165]). In the first case, the damage caused by the delayed filing for insolvency is the decreased ratio of satisfied creditor claims and, thus, the compensable damage extends only to the difference between the hypothetical and the actual ratio. In the latter case, by contrast, the creditor would have never contracted with the company, had he known that it was already insolvent; therefore, the new creditors can claim the loss they have suffered because of the conclusion of the contract, i.e. the difference of their hypothetical funds (had they not contracted) and their actual funds.[166]

Another civil liability towards creditors in the context of insolvency may result from criminal law, in particular from the protective rule on **grossly negligent encroachment on creditors' interests** (s. 159 of the Penal Code, StGB). This norm contains two criminal liabilities: One for the grossly negligent causation of insolvency and one for the grossly negligent damage of creditors' interests after the company has become insolvent. S. 159 StGB provides for an exclusionary list of behaviours, which constitute a breach: wasting assets (para 1); depleting the company's assets through extremely risky transactions outside of the normal business of the company (para 2); disproportionate expenditures (para 3); the failure to keep transparent business records (para 4); and the failure to produce annual accounts (para 5). This rule is protective and, therefore, can serve as a direct basis for creditors' claims in tort against the directors, if they breached it grossly negligently and, therefore, caused the creditors' loss.

5.1.2.3 Liability to the authorities

5.1.2.3.1 Liability for failure to pay taxes

According to s. 80(1) Federal Tax Code (BAO) the managing directors of a public limited company are obliged to make sure that **taxes** are being paid by the company and that the tax authorities are not treated worse than the company's other creditors. If the management board assigns a specific manager for this obligation, the others still have a certain duty to supervise this person, and if the board assigns a third party to this task (e.g. a tax adviser), the managers have a very strict duty to monitor this third party and, therefore, they can still be held liable because of negligence in this respect.[167]

[162] Illiquidity (s. 66 IO) means that the company is unable to pay for all of its due and payable obligations and will probably not be able to raise funds for payments in the near future. This definition is not found in the Insolvency Code but has been developed by the High Court in cases regarding the GmbH. RIS-Justiz RS0126559; RS0118268

[163] Over-indebtedness (s. 67 IO) means that the company's liabilities exceed its assets and, in addition, the company is unlikely to be able to survive in the medium term. Since all liabilities (irrespective of their due-date) are considered in this calculation, the insolvency case of over-indebtedness is usually reached at an earlier stage than illiquidity. This insolvency case is only valid for legal persons (and some other forms of companies) because of creditor protection considerations. RIS-Justiz RS0064886; RS0064962; OGH 2 Ob 268/98w; 1 Ob 144/01k

[164] *Altgläubiger*

[165] *Neugläubiger*

[166] Heiser (n39), 32; Adensamer/Eckert (n32), 255-256

[167] Adensamer/Eckert (n32), 263

Directors can be held liable by the tax authorities for payments the company should have made, to the extent that they have caused them to be uncollectable by a negligent breach of their duties arising from tax law. This liability is subsidiary to the company's general liability for its taxes – i.e. the directors can only be held liable for the amount of taxes, which couldn't be collected from the company as primary debtor.[168] The director's fault is being presumed, i.e. it bears the burden of proof for the lack of its fault.[169] The directors' liability is usually limited to five years from the end of the year in which the tax claim has arisen[170] and to ten years in the case of tax evasion.[171]

5.1.2.3.2 Liability for social security contributions

Social security institution can hold directors liable for the company's failure to make contributions to the extent that they have caused them to be uncollectable by a negligent breach of their duties imposed by social security law (s. 67(10) General Social Security Act, ASVG[172]). Like the directors' liability for taxes, this is also a subsidiary liability as opposed to the company's liability.[173]

5.1.3 Exemptions from liability

5.1.3.1 Ex-ante approval

According to s. 84(4) AktG the directors are not liable towards the company for their actions to the extent that they were acting in accordance with a lawful resolution of the general meeting, for example when the management board asked them to decide on a business matter or in other cases where shareholder approval is mandatory.[174] Please note, however, that the general meeting is competent to resolve upon a very limited number of issues only. In all other respects a shareholders' resolution would be deemed unlawful, unless requested by management (sec. 103 para 2 AktG). If the shareholders' resolution was unlawful (as regards its process or its substance[175]), it doesn't exclude the managers' liability. This is also the case if the management board has induced the resolution and acted contrary to their duty, for instance if they didn't collect the information required by the duty of care. An ex-ante approval of the supervisory board, as required in the cases of s. 95 AktG, does not exclude director's liability.

5.1.3.2 Ex-post approval

Since the shareholders don't have a general instruction right, they can generally not legitimise the managers' action by giving their ex post consent. Only in cases where the board must exceptionally obtain prior shareholder approval, they can legitimise the board's behaviour ex post so that the illegality of the management's actions lapses.[176] Since ex ante approval of the supervisory board generally doesn't affect the managers' liability, evidently ex post approval does not do so either.

[168] Heiser (n71), 265
[169] Adensamer/Eckert (n32), 265
[170] See s. 208(1) BAO
[171] See s. 207(2) BAO
[172] General Social Security Code, "*Allgemeines Sozialversicherungsgesetz*" (ASVG)
[173] Adensamer/Eckert (n32), 265
[174] According to s. 103(2) AktG the management board as well as the supervisory board may ask the general meeting for a decision on business matters. In other cases like for example mergers (s. 221) a prior shareholder resolution is mandatory.
[175] See especially s. 199 AktG
[176] Adensamer/Eckert (n32), 184

5.2 Liability of the supervisory board members

The supervisory board usually acts collectively, i.e. they usually act through resolutions of the organ. In this case, only the directors who approved of the proposal are faced with liability (because only their actions can have caused the damage), at least if dissenting members took all reasonable action to prevent the other members from taking such decision. Furthermore, an individual supervisory board member can be held liable for breaches of fiduciary duties. In addition, if the supervisory board consists of committees with different competences, usually only the committee in whose responsibility the respective case falls is liable for any misconduct in this matter, except where the other members have failed to monitor this committee or where the assignment of those responsibilities to the committee was negligent in the first place.[177]

Since the management board is exclusively entitled to represent the company, it is accepted that the supervisory board can usually not be held liable directly by third parties.[178] Exception may occur in connection with s. 48d(4) BörseG applying to persons with a "leading function" in the firm, resulting in the members of the supervisory board of listed companies being obliged to disclose any self-dealings with certain financial instruments (which amount to at least 5,000 Euros in value) to the Financial Markets Supervisor[179] as well as to the company.[180] This rule is a protective rule in relation to the company as well as the security holders and, therefore, a supervisory board member who is in breach of this duty is arguably liable for any damages caused to the company and the respective security holders, including shareholders.

5.2.1 Liability according to s. 99 and 84 AktG

Generally, the members of the supervisory board are liable for a breach of any duty that they owe to the company under the same conditions as the managers, i.e. when they cause a loss of the company by their negligent misconduct (see 5.1.1). In particular, a liability for the failure to properly monitor the management or for giving consent to a management activity (of the list in s. 95(5) AktG) of which they shouldn't have approved comes into question. Further, they could be held liable for appointing unqualified managers or for removing them too late.[181]

Pursuant to Supreme Court rulings decisions of the supervisory board will only be reviewed when they are "virtually unjustifiable"[182].[183]

5.2.2 Liability according to s 25 URG

If the company is in need of reorganisation (see above), but the supervisory board didn't give their consent to the managers applying for a reorganisation procedure, the members of the supervisory board are liable towards the company according to s. 25 URG and under the conditions of s. 22 URG[184] but with a cap of 100,000 Euros per person.

[177] Strasser (n11), s. 98-99, para 33 and 35
[178] Heiser (n71), 265
[179] *Finanzmarktaufsicht*, FMA
[180] See s. 48d(4) BörseG; Adensamer/Eckert (n32), 240
[181] Strasser (n11), s. 98-99, para 35
[182] *"geradezu unvertretbar"*
[183] RIS-Justiz RS0116173; OGH 7 Ob 58/08t
[184] See 5.1.1.4.1

5.2.3 Liability according to s. 100 AktG

See s. 5.1.1.3.

6 ENFORCEMENT OF CLAIMS

6.1 Enforcement of the company's claims against the managers

6.1.1 Enforcement by the company

Primarily, the general meeting is competent to authorise the supervisory board to enforce claims against the managers. If they do, the supervisory board is obliged to enforce the claim.[185] However, under certain circumstances the supervisory board may enforce a claim without shareholder consent and even contrary to a shareholder resolution,[186] namely when a liability of one of its own members is possible[187] and when the non-enforcement would be contradictory to its duty of care because this way the company might incur a loss and might be held liable for it by creditors.[188] In addition, in certain circumstances the management board can be responsible for enforcing the company's claims.[189]

6.1.2 Enforcement by the minority shareholders

Furthermore, a minority of shareholders who hold 10% or more of the company's capital are competent to either order the supervisory board to enforce claims against a manager or have a special representative appointed to enforce claims against a manager.[190] In certain cases the relevant threshold is lowered to only 5% of the company's capital.[191] However, the company may reclaim the litigation costs from the minority shareholders (once assigned to the company), which is why this mechanism is rather irrelevant in practice.[192]

6.1.3 Enforcement by creditors

S. 84(5) AktG provides that the creditors can enforce the company's claims against the directors to the extent that they cannot get satisfaction from the company and, generally, only where the directors have acted gross-negligently. However, negligence suffices in the cases of s. 84(3).

[185] See s. 134(1) AktG according to which the supervisory board must enforce claims against managers if the shareholders by majority resolution request it.
[186] See s. 97(2) AktG
[187] Reich-Rohrwig (n88)
[188] Bydlinski/Potyka in Jabornegg/Strasser (n11), s. 134, para 21; Adensamer/Eckert (n32), 198
[189] The management board is also solely competent to enforce claims against the supervisory board and against former management board members; Strasser (n11), s. 77-84, para 105
[190] They must make the request in the general meeting and in accordance with the usual procedural rules applicable to the general meeting. Irrespective of who represents the company in the lawsuit (the supervisory board or the special representative) the company is the party in the lawsuit. However, the minority shareholders may intervene according to s. 19 of the Civil Procedure Code (*Zivilprozessordnung*, ZPO).
[191] See s. 134(1) AktG
[192] Adensamer/Eckert (n32), 205

6.1.4 Enforcement by the insolvency administrator

If the company is subject to insolvency proceedings, the insolvency administrator is solely competent to enforce claims against the directors. Generally, any waivers and settlement agreements do not affect the insolvency administrator's ability to enforce claims.

6.1.5 Barriers to enforcement

6.1.5.1 Discharge resolution (s. 104(1) AktG)

At the annual general meeting the management board has to present the annual accounts to the shareholders, who then decide whether or not they pass a resolution discharging the management as well as the supervisory board. The resolution is the shareholders' general approval of the management for the last year. The AktG doesn't explicitly state the consequences of such resolution, but since the AktG explicitly conditions waivers on certain strict criteria (see below), evidently the discharge resolution cannot as such have the effect of a waiver.[193]

6.1.5.2 Waiver of liability and settlement agreements

The supervisory board is competent to waive claims against the managers and to conclude settlement agreements[194]; in addition, the shareholders must give their consent. S. 84(4) AktG third sentence provides that waivers and settlement agreements may only be concluded five years after the respective claim came into existence, and only if not a minority of shareholders, who hold equal to or more than 20% of the company's capital, blocks the decision. The five-year-restriction does not apply, if all of the shareholders give their consent.[195] Settlement agreements and waivers (and, thus, also discharge resolutions) have effect only in relation to the company, not in relation to creditor's enforcement rights. As a consequence, creditors as well as the insolvency administrator can enforce the company's claims irrespective of any waiver or settlement agreement between the manager and the company.

According to s. 28 URG the company cannot effectively waive the directors' liability in respect of the failure to apply for a company reorganisation procedure when the company was in need of reorganisation.

6.1.5.3 Statute of Limitation of Liability

According to s. 84(6) AktG any claims against the directors (irrespective of the claimant) can only be enforced within five years from the company's or the creditor's knowledge of the damaging events as well as the damaging person. With respect to the company it suffices that one of the members of the

[193] Only in the case where the discharge resolution fulfils the requirements of a waiver could it possibly have the effect of a waiver (Adensamer/Eckert [n32], 189).
[194] See s. 97(1) AktG, according to which the supervisory board is competent to represent the company as regards any transaction with the managers and to litigate claims against them which have been approved by the general meeting.
[195] See above

management board or the supervisory board[196] has knowledge of the mentioned facts triggering the five-year-limitation period.[197] In addition to this subjective limitation, the general objective limitation of 30 years is also applicable;[198] therefore, the claim against the manager definitely expires after 30 years, irrespective of anyone's knowledge of it.

Claims under general tort law – like most of the claims of the shareholders and creditors against the directors (see s. 5.1.2) – expire after three years from the point in time when the damaged person has come to know (or should have known) occurrence of the loss and the damaging person.[199]

According to s. 79(3) AktG the company's claims against managers concerning a breach of their duty not to compete are limited to three months after the remaining managers and all the members of the supervisory board have known the damaging event. In addition to this subjective limitation, an objective limitation of five years from the occurrence of the loss applies.

6.2 Enforcement of third party's claims against the managers

The management board is competent to enforce claims of the company against the members of the supervisory board because of their general competence to represent the company.[200] In addition, a minority of shareholders (s. 134 AktG) or – under certain circumstances – the creditors (s. 84 AktG) can enforce the company's claims against members of the supervisory board.[201]

6.3 Burden of proof

In accordance with the general rules, each party bears the burden of proof for the facts favourable for their own position. This is also true for the enforcement of claims against a public limited company's director. However, s. 84(2) AktG[202] provides for a shift of the burden of proof towards the director as regards the question of compliance with the standard of care. Thus, if the claimant has succeeded in proving a loss, the causation by the directors' behaviour and the illegality because of non-compliance with the law or the company statute, the director would have to prove that he didn't act negligently (i.e. rebut the accusation of fault). If the claimant has managed to prove the loss and the causation and the question is whether or not the director has breached his duty of care, he must prove that he didn't act negligently but rather applied the care of a prudent and conscientious business man, which implies the question of illegality as well as of fault.[203] In the cases of s. 84(3) AktG, in addition, the occurrence of a loss is being presumed and the director has to prove the opposite.[204]

[196] Since the supervisory board is competent to litigate claims against the managers, the knowledge of a supervisory board member definitely suffices to trigger the limitation, but because the management board is the organ, which is competent to represent the company in relation to third parties, arguably the knowledge of a manager also suffices (see Adensamer/Eckert (n32), 193-194).
[197] See s. 71(2) AktG
[198] Heiser (n39), 30
[199] S. 1489 ABGB
[200] Strasser (n11), s. 77-84, para 105
[201] See 6.1
[202] Also see s. 1298 ABGB
[203] Adensamer/Eckert (n32), 213-214
[204] Strasser (n11), s 77-84, para 108

7 CONFLICT OF LAWS

The question of the applicable law depends in a first step on the classification of the respective legal question, for instance, the qualification as a company law matter, tort law matter, contract law matter or insolvency law matter. This is especially important for directors' liabilities towards third parties because these liabilities are usually based on norms outside of company law and, thus, their classification can be ambiguous. Only in a second step the law applicable to a certain legal matter can be determined.

7.1 Company law matters

According to Austrian international private law, the law applicable to company matters is the law where the company has its real seat, i.e. the seat of its main business administration.[205] This rule is applicable to all companies, irrespective of whether they were incorporated in Austria or not.[206] Therefore, according to s. 10 IPRG, company law matters of a company with its real seat in Austria are governed by Austrian law; for example the capacity to be subject to rights and duties, the capacity to act, the incorporation, foundation and organisation of the company, the rights and duties of the shareholders and directors as well as the directors' liability towards the company.[207] However, in reaction to the European Court of Justice's decisions *Centros*, *Überseering* and *Inspire Art*, the OGH ruled that the real seat theory is not to be applied to companies incorporated in the European Union because this would be contrary to the freedom of establishment; in respect of such companies the seat of incorporation is the decisive factor to determine the applicable law. It is controversial though if the seat of incorporation has to be the decisive factor only in relation to issues like the foundation, legal personality, statute, etc. of the company or if this is the decisive factor also of broader issues of the company, for example, the determination of the law applicable to the company's claims against their directors.[208] However, after the ECJ's *Cartesio* decision, the prevailing view favours a comprehensive application of the law of the state of incorporation where the state of incorporation applies the incorporation seat theory, whereas s. 10 IPRG (Austria's real seat rule) is still applicable where the company's state of incorporation follows the real seat theory as well.[209] Therefore, the law applicable to the directors' liability towards the company is either the law of the state where the company has its real seat (if the company's state of incorporation also follows the real seat theory), or the state of incorporation, if the state of incorporation follows the incorporation seat theory. Further, the directors' liability towards the company according to s. 22 URG is also viewed as a company law matter.[210]

[205] See s. 10 International Private Law Code (*Internationales-Privatrechts-Gesetz* – IPRG)
[206] Georg Eckert, 'Sitzverlegung von Gesellschaften nach der Cartesio-Entscheidung des EuGH' GesRZ 2009, 139 (139); Adensamer/Eckert (n32), 271
[207] Adensamer/Eckert (n32), 273, 277
[208] Verschraegen in Rummel (n154), s. 10 IPRG, para 6 - 9
[209] Eckert (n211); Heidinger/Schneider in Jabornegg/Strasser (n3), s. 5, para 39; Verschraegen in Rummel (n154), s. 10 IPRG, para 9
[210] For a detailed discussion and sources see Eckert/Adensamer (n32), 280-282.

7.2 Tort law matters

Tort law matters in relation to civil and commercial law are regulated by the European Regulation "Rome II", which broadly defines the applicable law as the law, where the consequences of the damaging behaviour have occurred.[211] Liabilities arising from tort law would be most of the tortious claims of shareholders and creditors against directors, for example, the claims because of the failure to publish a prospectus, to disclose insider information and directors' dealings, and the grossly negligent encroachment of creditors' interests. Rome II explicitly includes tortious claims arising from environmental law[212] and, therefore, directors' liabilities towards third parties based on environmental law fall within its scope too. The applicable law is either the law of the state where the damage materialised or, if the damaged third party so requires, the law of the state where the damaging behaviour was set out.[213] Likewise, the Regulation explicitly includes tortious claims arising from competition law[214], which concerns the possible liability of managers towards third parties according to s. 2 and s. 1 UWG (for the publishing of an incorrect prospectus)[215]. This liability is also classified as a tort law matter and, consequently, the applicable law is broadly the law of the state where the anticompetitive behaviour has its effects on the market.[216] Further, the managers' liability towards creditors for breaches of the pre-contractual duty to provide them with the relevant information[217] falls within s. 12 of the Regulation.

7.3 Contract law matters

The Rome I Regulation contains the relevant conflict of laws rules for contractual matters. S. 4(1) contains a list of certain contracts with a given connecting factor; in all other cases the applicable law is the law of the state where the characteristic feature of the contract is performed, which will generally be the main residence of the party who performs the characteristic feature. However, the Rome I Regulation is not applicable to company law matters, which includes the directors' liability for the company's obligations.[218]

7.4 Insolvency law matters

In respect of insolvency matters the European Insolvency Regulation contains the relevant conflict of laws rules. According to s. 4, the applicable law is the law of the state that is the competent jurisdiction, i.e. the state where the debtor has his centre of main interests (s. 3). Therefore, the preconditions of the filing for insolvency, the procedure as well as the consequences of insolvency, are all subject to the law of the state where a court has declared its competence.[219]

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[211] However, outside of the Regulation's scope, Austria's s. 48(1) IPRG subjects tort law matters to the law of the state where the damaging behaviour has been acted out, except in the case where both parties have a stronger connection with a different jurisdiction (s. 1(1) IPRG).
[212] S. 7 of the Regulation
[213] *Claudia Rudolf, 'Europäisches Kollisionsrecht für außervertragliche Schuldverhältnisse - Rom II-VO' ÖJZ 2010/36, 304*
[214] S. 6 of the Regulation
[215] Adensamer/Eckert (n32), 230
[216] Rudolf (n247), 304
[217] See 5.1.2.2
[218] *Thomas Bachner/Georg E. Kodek, 'Österreichische Umgründungen und englisches Kollisionsrecht - Gesellschaftsrechtliche Gesamtrechtsnachfolge im Spannungsfeld divergierender Rechtssysteme' ZfRV 2011/4, 21*
[219] Adensamer/Eckert (n32), 276

Whether or not the scope of the Regulation extends to the duty to file for insolvency and to the respective liability[220] is highly controversial: The two main views are in favour of a classification as a company law matter or as an insolvency law matter (only a minor view argues for the classification as a tort law matter); therefore, the situation is highly uncertain in this respect.[221]

[220] Procrastination of filing for insolvency, see 5.1.1.4.2 and 5.1.2.2.

[221] For an extensive list of literature see Adensamer/Eckert (n32), FN 681 and FN 682. They argue that neither the conflict of laws rules regarding company law matters, tort law matters, nor insolvency law matters are applicable, but they set forth that the directors' duty to file for insolvency as well as their liability for procrastination of filing for insolvency follow their own conflict of laws rules according to s. 1(1) IPRG, which contains the sweeping clause of the strongest connection. This strongest connection is argued to exist with the state in which the debtor has his centre of main interests and, therefore, the applicable law to this duty and corresponding liability is (in effect) the same as for insolvency law matters (Adensamer/Eckert (n32), 282-288).

DIRECTORS' DUTIES AND LIABILITY IN BELGIUM

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CONTENTS

1 INTRODUCTION

The Belgian Company Code 1999 ("**CC**") provides broadly for three categories of companies: purely contractual companies, companies with incomplete legal personality, and companies with full legal personality. This report will only cover directors' duties and liabilities in the latter category, of which there are three types in Belgian law, namely:

(i) the private limited company (artt. 210-349 CC);

(ii) the cooperative society (artt. 350-436 CC); and

(iii) the public limited company ("**PLC**") (artt. 437-653 CC).

All references to the board of directors, individual directors, or other concepts in this report will be in relation to the PLC, unless the contrary is expressly stated.

1.1 Corporate law and directors' duties in Belgium

The sources relied on in this report reflect the civil law character of Belgian law. While case law is ignored at the practitioner's peril and Supreme Court judgements are not overruled lightly, the absence of a formally recognised doctrine of precedent or *stare decisis* means that statute is considered the most authoritative statement of the law, subject to the primacy of the constitution as safeguarded by the Belgian Constitutional Court. This report also mirrors the court's attitude towards the views of learned authors who are frequently, and less discriminately than in common law jurisdictions such as England and Wales, cited by judges. The CC has codified the main principles of company law in 1017 articles. Despite this high number, it is not an exhaustive statement of the law concerning companies and, especially in the realm of liability, has to be supplemented by general principles of tort and contract law set out in the Civil Code, which is of Napoleonic origin. Insolvency legislation, such as the Bankruptcy Act 1997, also contains provisions relevant to directors' duties.

1.2 Corporate landscape in Belgium

Before addressing the main topic of this report, a cursory glance at the general corporate landscape is required to set the scene. Belgian listed companies are characterised by high levels of ownership concentration, the prevalence of pyramids, voting alliances, and participation in family groups.[1] Belgium underwent a wave of privatisations in the early 2000s, but the financial crisis and the sovereign debt crisis have led to a modest resurgence of state involvement and outright ownership, especially in the banking sector.

The main exchanges in Belgium operated by NYSE Euronext are, in descending order of regulatory burden: Euronext Brussels, Alternext, and the "free market", which is a multilateral trading facility. The 20 largest Belgian companies are grouped in the BEL20 index, which is the benchmark stock market index of Euronext Brussels.

[1] R. W. Anderson and Malika Hamadi, 'Large powerful shareholders and cash holdings' (2009) http://eprints.lse.ac.uk/24422/1/dp631.pdf accessed 24 February 2012.

1.3 The board of a Belgian company

The board of directors is a collegiate organ. The individual directors are not organs of the company. This means that a decision by the board can lead to the liability of all directors, even those who did not agree. For example, art. 528 CC, which sets out the rules on liability for loss caused by a breach of the CC or the articles of association of the company, will only allow a director to be released from liability if two conditions are fulfilled: firstly, that they are not at fault; secondly, that they have denounced the breach at the first possible meeting of the general assembly to follow upon becoming aware of the breach.

This does not mean that the rules on liability are addressed to the board of directors as an organ, and not the directors as such. Instead, the legislator has relied in several instances on the concepts of joint and several liability or *in solidum* liability of the individual directors. Such liability will never be presumed (art. 1202 Civil Code), so it must be specifically provided for by law, for example the rebuttable presumption of joint and several liability for breaches of the CC or the articles of association in art. 528 CC. This has not stopped the courts from imposing joint and several liability in the event of a "common fault"[2] or from imposing *in solidum* liability in the event of a "concurrent fault,"[34] even without express statutory authority. This evolution has been subject to some criticism.[5]

A relatively recent corporate governance innovation has provided the board with the possibility to form an executive committee ("*comité de direction*"). Provided the articles of association allow the creation of this committee, directors are now permitted to transfer a large part of their competences to this body, except their competence as regards general policy and certain other competences that have to be retained by the board (art. 524*bis* CC). There are three main differences between the Belgian two-tier board structure and its Dutch or German counterparts:[6]

(i) the creation of an executive committee is not mandatory (FSMA – the Belgian financial authority – guidance strongly recommends that credit institutions establish such a committee);

(ii) it is composed of directors and/or non-directors; and

(iii) the board determines the extent of the transfer of powers.

The board of directors is charged with supervising the executive committee. According to our data, apart from credit institutions, only a negligible number of Belgian companies have adopted this two-tiered structure so far.[7]

The company law provisions on directors' liability in the CC (artt. 527-530) are applicable to members of the executive committee, and it is assumed by most authors that the other grounds of directors'

[2] 'Common errors' are errors where several persons *knowingly* cooperate in an event causing a loss.
[3] 'Concurrent errors' refer to the situation where the loss is caused by separate errors of different persons and each such fault contributes to the loss.
[4] Supreme Court 15 Februari 1974 [1975] Revue Critique de Jurisprudence Belge, 229, note by J.L. Fagnart.
[5] M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders* (Intersentia 2009), 27, citing H. De Page, *Traité élémentaire de droit civil belge*, III, *Les obligations*, 2 (Bruylant 1936), nr. 325.
[6] J.-M. Nelissen Grade, *Vennootschapsrecht – Capita Selecta* (2008-2009), 25.
[7] K. Geens and M. Wyckaert, (2010). Het gebruik van het facultatief duaal systeem in Belgische beursgenoteerde vennootschappen : enkele facts and figures. *TRV* (7), 527-538.

liability can be invoked, *mutatis mutandis*, against members of the executive committee,[8] even though members of the executive committee are not necessarily directors. However, various lacunae have been spotted in the legal provisions relating to this committee. Firstly, art. 198 CC, which prescribes periods of limitation for claims against directors, does not include members of the executive committee; and, secondly, it is not clear from the CC which organ can hold the members of the executive committee to account or can ratify their breaches, although parliamentary proceedings indicate that this ought to be the board of directors, given their duty of supervision and the nature of the delegation.[9]

Employee participation on the board is neither mandatory nor common in Belgian companies. However, employee influence can be exerted through the works council, composed of representatives of employees and employers. The law of 20 September 1948 regulates the creation of works councils in all companies with 100 or more employees and the renewal of works councils in companies with 50 or more employees. The works council has a right to consult and advise on the workings of the company, to expand or amend the labour regulations applicable to the company, to control whether those regulations are complied with, and to be informed of the current situation and prospects of the company, which will aid the works council in formulating opinions, advice, and objectives.

[8] Y. De Cordt and M.A. Delvaux, 'La responsabilité des dirigeants en droit des sociétés et en droit financier' in Y. De Cordt and D. Philippe (eds.), *La responsabilité des dirigeants de personnes morales* (Die Keure 2007), 14-15.
[9] Parliamentary proceedings 2000-01, nr. 1211/1.

2 The concept of 'company director' in Belgium

2.1 *De iure* directors

Belgian company law makes no *a priori* distinction, in terms of liability, between types of *de iure* directors, for example between executive and non-executive directors. It is up to the court to take into consideration the nature of the director's role when assessing whether a fault has been committed or when to rebut a presumption of joint and several liability.[10] Similarly, directors appointed by public authorities in state-owned companies cannot invoke their lack of independence or any other reasons related to the public nature of their appointment as a reason for escaping liability.[11] Public directors do not benefit from a specific legal regime as regards liability that deviates from general law.

The person responsible for the daily management of the company does not necessarily have to be a director (art. 525 CC). A daily manager does not have a director role in the company, and his liability will therefore not be like that of a director, unless the law expressly provides the contrary. For liability purposes, daily managers are only mentioned in art. 527 CC, which prescribes a director's liability to the company for errors committed in the exercise of management based on general law. Apart from this provision, daily managers will not be liable *as a director*. The other aspects of their liability in their capacity as daily managers will be regulated by the legal regime applicable to their appointment, for example employment law if the daily manager is an employee.[12] It should also be noted that in banks the management or executive committee is part of the board.

2.1.1 Requirements to become a *de iure* director

Apart from regulatory requirements, such as fit and proper tests, applicable to regulated entities, there are very few formal requirements to becoming a *de iure* director under general company law.

The board of directors must consist of at least three directors (art. 518 CC), unless there are no more than two shareholders. Directors do not have to be shareholders of the company. Except for directors named at the time of incorporation, directors have to be appointed by the general assembly.

2.1.2 Who can be *de iure* director

Apart from individuals, a legal person is allowed to be a *de iure* director of a company, but has to appoint a permanent representative from its shareholders, directors, or employees who is charged with performing the assignment in name and on behalf of the legal person. This permanent

[10] X. Dieu, '*Corporate governance*: W. Kent v Lenôtre' in *Mélanges Philippe Gérard* (Bruylant 2002), 209.
[11] *Cf.* M.-L. Steingers, 'Le statut légal des administrateurs publics ' [1980] Journal des Tribunaux, 576.
[12] M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders* (Intersentia 2009), 14-15.

representative is civilly and criminally liable as if he were performing the assignment in his own name and on his own behalf, notwithstanding the joint and several liability of the legal person. In other words, the permanent representative is liable as if he were a formally appointed director (art. 61 §2 CC).

2.2 *De facto* and shadow directors

Definition - Those persons exercising in fact the role of a director expose themselves to the same liability as their formally appointed counterparts. This applies both to civil and criminal liability.[13] In light of this, it is perhaps surprising that the CC fails to define the term *de facto* director. In fact, only art. 530 CC explicitly refers to *de facto* directors. Belgian case law has filled this gap and settled on a definition which states that a person is a *de facto* director if that person performs positive, independent acts of management.[14] Controversy remains as to whether merely influencing a director, as opposed to actually performing the act of management, suffices to qualify someone as a *de facto* director, but mere advice or suggestions seem insufficient.[15] Hence, subject to the usual disclaimer that any attempt to conflate legal concepts of two distinct jurisdictions will often obscure rather than enlighten, whether there is a concept equivalent to the shadow director in English law is unclear,[16] although certain authors submit that in Belgian law *de facto* directors encompass both *de facto* and shadow directors.[17]

Reach - Concerning the application of directors' liability to *de facto* directors, see *infra*.

[13] Supreme Court, 2 December 1963 [1965] Revue Pratique des Sociétés Civiles et Commerciales, 13, note by J. 'T Kint ; P. Van Ommeslaghe, 'La responsabilité du banquier dispensateur du crédit en droit belge' [1979] Revue de la Banque, 33-34.

[14] Court of Appeal of Liege, 13 February 2007 [2007] Revue Régionale de Droit, 145; Court of Appeal of Antwerp, 10 September 2004 [2005] Limburgs Rechtsleven, 41.

[15] For a discussion, see M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders* (Intersentia 2009), 9.

[16] For the distinction between *de facto* and shadow directors in English law, see *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180.

[17] M. Wyckaert and F. Parrein, 'Een ongeluk komt nooit alleen. Hoe weegt de insolventie van de vennootschap op de bestuurdersaansprakelijkheid?'[2011-2012] Themis cahier, 27.

3 The scope of directors' duties under Belgian law

Belgian law in general and company law in particular is difficult to analyse in terms of duty. Not only is this due to a dearth of statutory provisions and case law authority, but also due to the structure of Belgian company law in this respect, which centres much more on the liability side of the equation, as opposed to the duty side. Furthermore, it is still unclear to whom the duties that have been identified are owed.

These problems are compounded by the structure of Belgian tort law. Unlike English law, Belgian tort law is not premised on a loss caused by the breach of a duty of care owed to the claimant, but is expressed in more general terms as follows: "any human act causing a loss to someone else obliges the person who is to blame for the loss to provide compensation" (art. 1382 Civil Code). This statutory definition sets out the three elements of tortious liability: fault, loss, and causation. Although a fault can consist of a breach of a general duty of care, its ambit is wider in that it can also encompass breaches of statutory obligations that cause a loss to a claimant.

3.1 Types of directors' duties

A director has a general duty to act in the company's interest. This duty is not codified, but is inferred, by both case law and legal doctrine, from the functional nature of a director's mandate and the civil law obligation to perform his service contract in good faith (art. 1134, 3 Civil Code). Several duties follow from this, such as a general duty of loyalty from which, in turn, a duty not to compete, a duty of discretion and a duty to avoid conflicts of interest derive.[18]

In the event of a financial conflict of interest with a decision of the board of directors or a transaction that will be entered into, a director has a duty to notify the other directors before the board takes its decision, or enters into the transaction. The director's explanation, and possible justification, for the financial conflict have to be included in the board minutes. A director of a company that has issued securities to the public may not participate in the proceedings of the board on this matter, nor may he vote on it – there is no such prohibition for PLCs whose shares are not publicly traded (*infra*). The company can have the decision or transaction declared void provided they were taken or entered into in violation of the above procedures and the other party to the decision or transaction was or ought to have been aware of this violation (art. 523 CC). A similar provision exists for members of the executive committee (art. 524*ter* CC).

[18] *Cf*. S. De Dier and A. Van Bever, 'Zo zijn we niet getrouwd – over de loyaliteitsplicht van werknemer en bestuurder' [2008-2009] 3 Jura Falconis 321-391.

3.2 To whom are the duties owed?

Directors' duties are owed to the company, not to its shareholders. Ultimately, directors must seek to advance the company's interest. The company's interest is a concept that pervades the whole of Belgian company law and is an extension of the general law principle of good faith (art. 1134, 3rd sentence Civil Code).[19] However, the principle is broad and relatively vague. This is exacerbated by the lack of a statutory definition. There is sufficient doctrinal agreement to support the notion that it encompasses the interest of the company as a legal entity and the interest of the shareholders.[20] Whether it protects the interest of other stakeholders, such as employees and creditors, is less certain, although a recent Royal Decree has set this wider interpretation as the applicable standard in the particular context of take-overs for information purposes.[21] It has been suggested, however, that the wider interpretation is an inappropriate standard in the context of directors' liability,[22] except in crisis situations, where there is some (pragmatic) agreement that the wider interpretation ought to prevail to protect the interest of present and future stakeholders, including creditors.[23]

This must be nuanced in light of the *Rozenblum*-doctrine, based on the eponymous French Supreme Court case, which has also acquired a significant doctrinal and case law support in Belgium.[24] This doctrine permits a director to take into account the group interest when assessing the corporate interest, provided the following conditions are met:

(i) the existence of a structured and organised group, of which all components contribute to the realisation of a common (social, financial or economic) goal, determined by the leader of the group;

(ii) the balance of the respective obligations of the group companies may not be permanently disturbed; and

(iii) no member of the group is 'sacrificed' by imposing obligations which it cannot financially bear.

In these circumstances a director may act in a way which does not further the immediate, individual corporate interest of this particular member of the company group. In spite of this important clarification in the context of company groups, it remains difficult to delineate the exact boundaries of the duty to act in the corporate interest in the case of groups.

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[19] L. Fredericq, *Traité de droit commercial belge*, V (Feyheyr 1950), 699-700.

[20] *Cf*. A. Francois, *Het vennootschapsbelang in het Belgische vennootschapsrecht* (Antwerp, Intersentia, 1999).

[21] Art. 28, §1, 1° Royal Decree 27 April 2007.

[22] Y. De Cordt and M.A. Delvaux, 'La responsabilité des dirigeants en droit des sociétés et en droit financier' in Y. De Cordt and D. Philippe (eds.), *La responsabilité des dirigeants de personnes morales* (Die Keure 2007), 21.

[23] I. Corbisier, 'Pour une nouvelle dimension contractuelle et un personnalité morale non obligatoire en droit des sociétés', in *Rapport aux XIVèmes Journées d'études juridiques Jean Dabin* (UCL 1992), 15; M. Delierneux and Y. Stempnierwsky, 'Le banquier et l'entreprise en difficulté : quelques réflexions relatives à la restructuration de la dette et à la renégociation des contrats', in *Mélanges Jean Pardon* (Bruylant 1996), 225-227; Freshfields, 'A guide for directors of subsidiary companies in Belgium', http://www.freshfields.com/publications/pdfs/2011/aug11/30806.pdf, 10. Contra : Francois, *Het vennootschapsbelang in het Belgische vennootschapsrecht* (Antwerp, Intersentia, 1999), 438.

[24] *Cf*. Court of Appeal of Brussels, 16 June 1981 [1981] Revue Pratique des Sociétés, 145; E. Wymeersch, 'De houding van de Bankcommissie tegenover het groepsverschijnsel', in *Rechten en plicthen van moeder-en dochtervennootschappen* (Kluwer, 1985), 393-444.

3.3 The director as a shareholder

The *extent* to which directors in their capacity as shareholders, when exercising their right to vote, have to act in the interest of the company is disputed. Although it is accepted that a shareholder can abuse his right to vote, a shareholder may also use his right to vote to preserve his own financial interests. The difference between the position of directors and shareholders in this respect is illustrated by the conflict of interest provisions: while directors are subject to the strict rules in art. 523 CC, the law does not forbid them to vote for their own appointment or the ratification of their breaches.[25]

3.4 The time span of the duties

Since most duties (e.g., the duty to not compete, which is relevant in case of corporate opportunities, but also the duty of confidentiality) are derived from the contract law obligation to perform in good faith, duties cease to exist when the director's service contract ends (through resignation or dismissal). It is, however, possible to contractually define non-compete or non-disclosure duties that have effect after resignation, and which must specify a reasonable (i.e. not too long) time frame (and spatial sphere) in which the respective duty remains in place (and can be enforced by the company when infringed). Also, a resignation might not be effective immediately and therefore not release the director from liability for later facts (see, *infra*, on the time span of liability).

3.5 Application of duties to *de facto* and shadow directors

It must be noted that, for the purpose of liability, *de facto* directors are only mentioned in art. 530 CC concerning serious fault contributing to bankruptcy and in art. 492*bis* Penal Code, so their liability will mostly be based on general law principles. For want of a contractual relationship with the company, the general law principles on which to base a claim in liability will be confined to tort law (art. 1382 Civil Code). Indeed, the qualification as a *de facto* director implies that their interference with the management of the company is without a legal or contractual basis.[26] In sum: in case of a breach of the general duty of care (art. 1382 Civil Code) or when art. 530 CC or art. 492*bis* Penal Code apply (*infra*), *de facto* directors can also be held liable. As regards other liabilities (art. 527-529 CC), it remains doubtful whether they also apply to *de facto* directors. This is contested in the literature, and case law has not yet been able to decide on this matter.[27]

[25] J.-M. Nelissen Grade, *Vennootschapsrecht – Capita Selecta* (Leuven 2008-2009), 57.
[26] Commercial Court of Turnhout, 10 December 2007 [2008] Rechtspraak Brussel Antwerpen Gent, 502, note by B. Huylebroeck.
[27] V. Carron, 'De feitelijke bestuurder', VENA 2005, 72.

4 LIABILITY FOR BREACH OF DUTY

In principle, an act of an organ is legally an act of the company, which means that a director acting within his actual or apparent authority will not be personally bound by it (art. 61 §1 CC; "organ theory"). Over the years, more and more statutory inroads have been made against this basic principle, resulting, according to the estimate of an esteemed academic,[28] in some ten grounds of personal liability, both civil and criminal. Most of these rules will be discussed in detail below. The aim of this subsection is to identify the general law underpinnings of some of these rules. This can best be done by analysing directors' liability to third parties separate from liability to the company.

As a preliminary point, it is useful to bear in mind the distinction between obligations of means and obligations of result. For example, statutory obligations will often be considered obligations of result. The obligation is deemed to be breached when the result is not reached, but this presumption can be rebutted. In the event of non-compliance or breach, the burden of proof will be on the director to prove that the failure to comply is due to an extraneous cause and is not attributable to him or her.

Obligations of means require the claimant to prove that the director is to blame for a breach, which amounts to proving that a reasonable and careful director, placed in the same circumstances, would not have done the same. This means that the assessment will be stricter when the director is a professional.[29] The Council of State, in its advisory capacity (in which it scrutinises draft legislation by giving advice), is of the opinion that a judge can take into account non-binding corporate governance standards to help him coming to a conclusion whether a breach is committed,[30] although this has been criticised by legal authors because corporate governance rules do not necessarily reflect wider public standards.[31]

In assessing a breach of an obligation of means, two caveats apply. Firstly, the facts must be judged based on the circumstances that prevailed at the time, and the information that was available. Secondly, a judge may not substitute his business judgment with that of the director, in that there can only be a fault where the contested decision falls beyond the margin of what careful and thoughtful directors could have divergent views on.[32] This so-called "margin of appreciation"[33] is a more subjective and abstract version of the US business judgment rule.[34]

Although the analytical framework for judging contractual and extra-contractual (tortious) liability is very similar, this does not mean that each fault will lead to a director being liable both in contract and in tort. For example, payment of a certain obligation before the due date could result in contractual liability to the company without this leading to liability in tort to the third party.[35]

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[28] J.-M. Nelissen Grade, *Vennootschapsrecht – Capita Selecta* (Leuven 2008-2009), 40.
[29] This reflects the law of agency principle in art. 1992 Civil Code that unpaid agents will be judged more leniently than paid agents.
[30] Advice of the Council of State, Parliamentary Documents, Chamber of Representatives 2005-06, nr. 2111/002.
[31] M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders* (Intersentia 2009), 131-132.
[32] J.-M. Nelissen Grade, *Vennootschapsrecht – Capita Selecta* (Leuven 2008-2009), 37.
[33] J. Ronse, 'Marginale toetsing in het privaatrecht' [1997] Tijdschrift voor Privaatrecht, 207.
[34] Y. De Cordt and M.A. Delvaux, 'La responsabilité des dirigeants en droit des sociétés et en droit financier' in Y. De Cordt and D. Philippe (eds.), *La responsabilité des dirigeants de personnes morales* (Die Keure 2007), 23.
[35] M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders* (Intersentia 2009), 132.

One further preliminary point must be borne in mind in relation to liability: it is established by the courts that a lack of involvement and material or mental incapacity will not prove a shield against liability claims.[36] On the contrary, a lack of involvement and a failure to perform duties could constitute a serious fault on the part of a director towards his company, and could be interpreted to constitute a breach of the CC or articles of association towards the company and third parties.

4.1 Liability to third parties

Liability to third parties is also called 'external liability' and is governed by principles of contract law and tort law.

4.1.1 Contract law

In the event a third party is suing for breach of contract, problems are unlikely to arise. If the company is in breach of contract, the third party will have no recourse to the director for want of a contractual relationship with him. This is nothing more than a logical application of the "organ theory" described above. Furthermore, the private law doctrine of "quasi-immunity for execution agents," which has been held to be applicable to directors,[37] prevents a contracting party from claiming against a director who commits a tort in the course of the execution of a contract, unless certain stringent conditions apply. These imply that the breach of contract is also a breach of the general duty of care;[38] and, secondly, this breach caused harm that is distinct from the harm caused by the wrongful execution of the contract. These conditions are unlikely to be fulfilled unless the director's tortious conduct also constitutes a criminal offence.[39] The doctrine of quasi-immunity, as has recently been confirmed by the Supreme Court, will not shield a director from a *pre*-contractual liability claim arising out of the negotiations leading to a contract (*culpa in contrahendo*)[40] because these claims, by definition, do not arise during the execution of a contract and are to be brought under the principles of general tort law.

4.1.2 Tort law

This brings us to tort based claims. For want of a contractual relationship with the director, art. 1382 Civil Code will be the most likely course of action for a third party. Liability in tort can be established for breaches of the general duty of care (art. 1382 Civil Code), which includes statutory breaches, no matter how slight the breach is. This is tempered by the fact that breaches of the general duty of care are assessed in a similar way to breaches of obligations of means, namely whether a reasonable and careful director, placed in the same circumstances, would have done the same.

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[36] Court of Appeal of Ghent, 8 February 2001 [2003] Recueil annuel de jurisprudence en droit des sociétés commerciales, 211; Court of Appeal of Ghent, 9 May 2005 [2005] Tijdschrift voor Rechtspersoon en Vennootschap, 480.
[37] Supreme Court, 7 November 1997 [1998] Tijdschrift voor Vennootschapsrecht, 284.
[38] Cass. 7 November 1997, *Pas*. 1997, I, 1146.
[39] K. Geens and J. Vananroye, 'Burgerrechtelijke en strafrechtelijke aansprakelijkheid in de vennootschappelijke context, met inbegrip van het misbruik van vennootschapsgoederen' [2001-2002] Themis Cahier 5, 15.
[40] Supreme Court, 20 June 2005 [2005] Pasicrisie, 1354, overruling Supreme Court, 16 February 2001 [2001] 7 Arr. Cass., 303.

According to the "organ theory" outlined above, any wrongful act committed by a director acting within his authority will be attributed to the company. However, the reverse – that a director is personally liable to third parties for wrongful acts committed by the company – is not necessarily true.[41] For a director's personal liability to be engaged, an *individual* fault is required. For example, breaches of statutory obligations by the company will not automatically lead to the personal liability of the director, if that statutory obligation is addressed to the company, as opposed to the director. To that effect, the Supreme Court has held that a director will only be liable for a late declaration of bankruptcy, which is a statutory obligation of the company,[42] if it is proven that he is to blame for failing to make such a declaration; such proof is not adduced by the mere fact that there was a failure to declare cessation of payment within the legally allowed period after the bankrupt company ceased to pay.[43] The claimant will have to prove that the individual director knew or ought to have known that a declaration had to be filed.[44] However, since a director is responsible for supervising the company's financial situation, such knowledge will be easily imputed.[45]

It could be that a fault in the exercise of a director's management simultaneously breaches the general duty of care (art. 1382 Civil Code), in which case there is a co-existence of liability. Special rules apply (*infra*).

4.2 Liability to the company

Liability to the company is referred to as "internal liability," which is mostly based on contract law principles.

4.2.1 Contract law

Pursuant to art. 527 CC, directors, members of the executive committee, and day-to-day managers are liable to the company at general law for errors committed in the exercise of their management ("management errors"). General law is here taken to refer to general contract law. In previous versions of the CC, references were made to the law of agency. These references have now been omitted, as a directorship is now no longer seen as merely an agency contract with the company, but as an unnamed, mixed contract to which the rules of agency can be applied by analogy, where appropriate and reasonable.[46]

An error in this context means that a director has not correctly fulfilled his mandate and has not managed the company in its best interest.[47] The corporate interest therefore has a role to play in the appreciation of the error (see *infra*). The duty to act in the company's corporate interest will be judged

[41] Unless a presumption to that effect applies (see below).
[42] Art. 9 Bankruptcy Act 8 August 1997.
[43] Supreme Court 10 May 1990 [1989-1990] Arr. Cass, 1196.
[44] Supreme Court, 22 September 1988 [1990] Revue Critique de Jurisprudence Belge, 203; Supreme Court, 7 September 1990 [1991] Tijdschrift voor Rechtspersoon en Vennootschap; K. Geens and J. Vananroye, 'Burgerrechtelijke en strafrechtelijke aansprakelijkheid in de vennootschappelijke context, met inbegrip van het misbruik van vennootschapsgoederen' [2001-2002] Themis Cahier 5, 19.
[45] K. Geens, 'Overzicht van rechtspraak. Vennootschappen 1992-1998' [2000] Tijdschrift voor Privaatrecht, 320.
[46] *Cf*. J. Ronse, *Algemeen deel van het vennootschapsrecht* (Acco 1975), 346.
[47] O. Ralet, *Responsabilité des dirigeants de société* (Larcier 1996), 90.

as an obligation of means.[48] The slightest fault suffices to trigger the director's responsibility, although this has to be judged in light of the two abovementioned caveats regarding obligations of means.

Examples of managerial errors are:

- The continuation of an obviously insolvent company's activities when this is not reasonable, i.e. it is clear that the company would become insolvent (although there is no wrongful trading rule in the CC, the interpretation of art. 527 CC by established case law leads to results comparable to the Anglo-Saxon 'wrongful trading' rules; see also *infra*, "co-existence of liability");
- The entering into contracts that the company could not possibly honour;
- Leaving company debts unpaid or credits unused;
- The neglect of the directors' supervisory functions;
- Negligent book-keeping;
- Systematic absence at board meetings; and
- Any action that goes against the company's interest.

Certain aspects of a director's contractual liability are obligations of result. For example, the duty to personally execute his mandate is an obligation of result. This encompasses participating in meetings and being actively involved in the management of the company.[49]

4.2.2 Tort law

Formally appointed directors will only be internally liable in tort when the doctrine of concurrent actions applies. The director's liability may be based on art. 1382 Civil Code to the extent that the negligent act is not only a breach of the company contract, but also of the general obligation of prudence and diligence, i.e. the standard formulated in art. 1382 Civil Code. Moreover, according to well established case law, the damage caused has to be different from the one flowing from the breach of the contractual obligation. In practice, this double condition restricts this liability to cases of violation of provisions of a criminal nature because committing a crime can never be the subject of the director's contract.

If the concurrent actions doctrine applies, the claim will still have to comply with the rules on company actions or "*actio mandati*" (see *infra*).[50] Exceptions to this are *de facto* directors, who can only be held liable in tort because they do not have a contractual relationship with the company.

[48] Court of Appeal of Ghent, 25 September 1987 [1989] Tijdschrift voor Belgisch Handelsrecht, 163; J. Ronse en K. Van Hulle, 'Overzicht van rechtspraak (1968-1977): vennootschappen' [1978] Tijdschrift voor Privaatrecht, (681) 817.

[49] M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders* (Intersentia 2009), 63.

[50] *Ibid*, 123.

4.3 Other grounds of liability

In this section we will examine grounds of liability that build on, or deviate from, the general civil law principles illustrated above.

4.3.1 Company law

On several occasions, this report has alluded to the liability provisions in the CC. Some of these, such as art. 527 CC, reflect general law principles. We will now turn to the remaining provisions which have not been discussed yet, in so far as they differ from the general law principles.

4.3.2 Breach of CC and articles of association

The directors will be *jointly and severally* liable to the company and third parties for breaches of the CC and the articles of association (art. 528 CC). The rationale behind this rebuttable presumption of joint and several liability for these types of breaches is that it is presumed that such a grave fault can only take place as a result of the directors' negligent supervision.[51] A director can only rebut this presumption by demonstrating that he:

- (i) did not participate in the contested decision (e.g. by remaining absent from the meeting (where this absence was excusable) or by having voted against the decision);
- (ii) is not blameworthy; and
- (iii) challenged the decision at the earliest general assembly meeting (or, in case of members of the executive committee, the earliest meeting of the board of directors).

In other respects, the same principles apply to this type of liability as to liability for breaches of other statutory obligations, discussed above. Most sections of the Companies Code and the articles of association, however, involve obligations of result, so that there is no room for judicial appreciation. Furthermore, art. 528 CC combines both internal (towards the company) and external (towards third parties) liability.

An example is a director's duty to call a meeting of the general assembly within two months after it ought to have been established that the company's net assets have fallen below half of the company's registered capital (art. 633 CC).[52] Aside from the presumption of joint and several liability, the law also refutably presumes that any loss incurred by *third parties* will be due to the failure to call the meeting (art. 633, 5th paragraph). This presumption of causation does not apply to losses incurred by the company. Another example is the late submission of the company's accounts for approval to the general meeting (art. 92 CC). A similar presumption of loss for *third parties* is applied in this respect.

4.3.3 Liability in the event of bankruptcy

Art. 530 §1 CC creates a special liability regime for directors (and *de facto* directors) of a bankrupt company. This claim can only be brought if, on the one hand, bankruptcy has been declared; and, on the other, the assets of the bankrupt company have proven insufficient to meet all the liabilities.

[51] J. Van Ryn, *Principes de droit commercial* (Bruylant 1954), 400.
[52] *Cf*. M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders* (Intersentia 2009), 97-121.

Art. 530 CC, contrary to general law, allows individual creditors to sue for their proportionate share in the collective loss on bankruptcy. This is not where the differences with general law end. Indeed, art. 530 §1 CC differs in such a way from the three elements of responsibility – fault, loss, causation – as they are classically interpreted, so as to make them almost unrecognisable.[53]

Firstly, while under general law even the slightest fault constitutes a fault for liability purposes, art. 530 §1 CC requires an obviously serious fault, which has been defined as "inexcusable recklessness verging on fraud."[54] An attenuating factor here is that the addition of the word "obviously" implies that the fault must be deemed serious by "every reasonable man" (*cf*. the abovementioned "margin of appreciation"-test). As of the Law of 4 September 2002 amending the Bankruptcy Act 1997, an obviously serious fault will be irrefutably presumed in cases of "serious and organised tax fraud," giving the tax authorities a special right of action against the directors.

What constitutes serious fault has been illustrated in the case law: a serious error, mistake, or negligence that no reasonable or responsible director would commit, that exceeds the limits of reasonable care and understanding of a normally diligent director. The following elements have been taken into account: no oversight of the manager who was able to continue his mismanagement, trading without a minimal accounting system; a director disposing of assets of the company in favour of another company, and this without any consideration leading to the company's default;[55] the granting of loans to another company without any security and in the reasonable knowledge that the latter company will not be able to repay the loans; the substantial transfer of assets between companies below market price and against the interests of the transferor; tax fraud, especially on VAT (VAT triangular export/import transactions allowing false invoices and VAT fraud); the withdrawal of considerable sums by a director, leading to considerable interest payments for outstanding bank loans.

Secondly, the requirement of causation has been significantly relaxed, giving the judge large leeway to hold directors accountable. Under general law, the causal link between fault and loss must be such that, but for the fault, the bankruptcy would not have occurred. For the purpose of art. 530 CC, it is sufficient for the serious fault to have contributed to the loss. However, when at the time the serious fault was committed the company was already virtually bankrupt, the fault, however serious, cannot be deemed to have contributed to the bankruptcy.

Thirdly, and this has been considered the most characteristic difference with general law principles,[56] the judge can allocate the loss at his discretion.[57] The judge may decide – but is not obliged – to hold the director liable for all or part of the deficiency, and this irrespective of a causal relation between the fault and the quantum of liability. The judge is also free to decide whether to hold directors who

[53] *Cf*. J.-F. Goffin and G. de Sauvage, 'Nouveautés dans les responsabilités: les dirigeants et les obligations fiscales et sociales de la société, les commissaires', in *Le point sur le droit des sociétés – Séminaire organisé à Liège le mai 2011* (Bruylant 2011), 158.

[54] J. Ronse, 'La responsabilité facultative des administrateurs et gérants en cas de faillite aves insuffisance d'actif' [1979] Revue Pratique des Sociétés, 300.

[55] This may be criminal conduct in case the provisions on waste of company assets are met ("abus de biens sociaux").

[56] J.-F. Goffin and G. de Sauvage, 'Nouveautés dans les responsabilités: les dirigeants et les obligations fiscales et sociales de la société, les commissaires', in *Le point sur le droit des sociétés – Séminaire organisé à Liège le mai 2011* (Bruylant 2011), 169.

[57] *Cf*. Court of Appeal of Brussels, 15 November 2007 [2009] Revue de Jurisprudence de Liège, Mons et Bruxelles, 305.

committed a serious fault jointly and severally liable. The only limit to this discretion is that directors cannot be liable for an amount in excess of the insufficiency of the assets (in respect of the debts). The legislator considered that this remedy, copied from a similar French provision,[58] would somewhat alleviate the risk of too severe liability, especially for cases of very large bankruptcies, although in practice this is not very convincing due to the extensive nature of the liability.

Art. 530 §2 CC contains additional rules in favour of the Belgian Social Security Service ('BSSS') if, upon bankruptcy, social security contributions and related claims remain unpaid. In these circumstances, the directors who committed a serious fault that is at the root of the bankruptcy, may be held jointly and severally liable as a result of a claim by the BSSS or the trustee in bankruptcy. Some authors conclude that the lack of the word "obviously" means that the "margin of appreciation"-test does not apply and the judge can be guided by his personal judgment. Whether in reality this will materially affect the outcome remains uncertain.[59] It is also unclear whether "at the root of" is meant to be a stricter causation requirement than "contributed to," or whether this is a result of bad drafting.

4.3.4 Duty of loyalty

4.3.4.1 General duty of loyalty

As mentioned earlier, the general duty of loyalty is not codified in Belgian company law, but inferred from the civil law obligation to perform contracts in good faith (art. 1134, 3 Civil Code). The duty of loyalty thus encompasses other duties, such as a duty of confidentiality and a duty not to compete with the company (both in activities and in mandates). The elaboration of these duties is largely the work of doctrinal interpretation and (scarce) judicial application of general civil law principles.[60]

The duty of confidentiality means that a director should refrain from revealing sensitive company information. The borders of what exactly is sensitive information and when it is harmful to disclose such information are largely subject to doctrinal debate and thus still unclear. Case law is rare on this point, and legal doctrine often looks to employment law for inspiration on what can be disclosed and what cannot.

The duty not to compete is, however, somewhat more elaborated, although the CC confines itself to one particular example of breaching the duty of loyalty, namely conflicts of interest (*infra*), and judicial applications still remain scarce. First, directors need to refrain from activities that compete with their company's activities.[61] Secondly, the cumulation of mandates in various companies is as such not prohibited, but can lead to a breach of the duty of loyalty when the mandates are held in competing companies, or when the cumulation keeps the director from executing his mandate in a proper way.

[58] Known as the 'action en comblement de passif', now amended.
[59] J.-F. Goffin and G. de Sauvage, 'Nouveautés dans les responsabilités: les dirigeants et les obligations fiscales et sociales de la société, les commissaires', in *Le point sur le droit des sociétés – Séminaire organisé à Liège le mai 2011* (Bruylant 2011), 160-161; J.-M. Nelissen Grade, *Vennootschapsrecht – Capita Selecta* (2008-2009), 43; M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders* (Intersentia 2009), 191.
[60] For an overview, see S. De Dier and F. Parrein, 'Niet-concurrentieverplichtingen in de vennootschap', *Liber amicorum Luc Weyts*, Brussels, Larcier, 2011, 638ff; J. Devogele, 'Droit d'investigation et devoir de discrétion', *DAOR* 2007,89ff; K. Geens and M. Wyckaert, 'Discretie of transparantie in het vennootschapsbelang', *Liber amicorum Eddy Wymeersch*, Antwerpen, Intersentia, 2008, 51ff.
[61] Pres. Comm. Leuven 6 May 2004, *DAOR* 2004/72, 53.

When the director resigns, his contract with the company ends (*supra*). According to civil law, any contractual duty not to compete after resignation contradicts the principle whereby persons can freely engage in competition with each other. As a result, such duty needs to be in line with reasonableness and cannot keep a director tied for too long or have an extremely wide scope.

4.3.4.2 Conflicts of interest

Belgian company law contains a specific regime addressing conflict of interest situations for board members: when a director has a proprietary conflict of interest as regards a decision the board is about to take, certain formal requirements have to be fulfilled. According to art. 523 CC, the conflicted member has to inform the board beforehand and must inform the company's auditor. The conflicted director has to report about the transaction in the minutes of the board and explain its justification. In general, according to the law, the conflicted member is not obliged to abstain from taking part in the vote, reflecting the position of many small companies, where directors and shareholders are largely the same. The company charter will sometimes contain an obligation to abstain, strengthening the duty of loyalty. However, for companies whose shares are spread amongst the public this changes significantly: a director of a company that has issued securities to the public (a category which includes listed companies (art. 438 CC) may not participate in the proceedings of the board on this matter, nor may he vote on it (art. 523 § 1, 4 CC).

A similar rule applies to conflicted members of the executive committee (art. 524*ter* CC). The charter may provide that in the case of conflicted members of the executive committee, transactions will be submitted to the board of directors for final decision.

Within a listed group of companies, the regime applicable to transactions in which members of the board or of the executive have a conflicting interest can be applicable together with a second conflict of interest regime; this time between a listed company and its parent company. Art. 524 CC contains an elaborate regime dealing with intra-group transactions involving listed companies, submitting these transactions to advice by the parent's independent directors, assisted by an independent external adviser, and subject to full board approval. Ample disclosure is provided for.[62] As far as the liability regime is concerned, the members of the board are jointly liable for damages suffered by the company or by third parties due to these intra-group transactions under the same conditions as discussed in the next paragraphs.

A specific liability regime for conflicts of interest (in the aforementioned cases of art. 523/524/524*ter* CC) is provided for by art. 529 CC. It states that all directors are jointly liable for the damaging consequences of conflicted transactions suffered by the company or by third parties to the extent that the transaction has resulted in an unjustified, i.e. excessive, advantage to the director to the detriment of the company.[63] The same rules are applicable to conflicted transactions entered into by the members of the executive committee.[64] Liability pursuant to art. 529 CC for conflicted transactions applies even if the formal requirements of art. 523/524/524*ter* CC have been fully complied with. The possibility of art. 528 CC to rebut liability (*supra*), however, still stands. In case the conflict situation

[62] See art. 524 CC for more details.
[63] This requirement is satisfied if the two sides of the transaction are manifestly imbalanced.
[64] But not if the transaction has been decided by the board of directors.

has not been reported to the board, the board members that were unaware will thus have to rebut the presumption that they acted with fault.

Finally, breach of art. 523/524/524*ter* CC is also sanctioned by rescission: the company (and only the company) can ask for the decision or transaction made in breach of these sections to be rescinded (annulled). The company can, however, only do so if the persons dealing with the company in respect of the involved decision or transaction were or ought to be aware of the breach (art. 523 § 2/524 § 6/524ter § 3 CC).

4.3.4.3 Corporate opportunities

Considering what was said before, it comes as no surprise that the doctrine of 'corporate opportunities' is largely developed by the literature. As the procedure regarding conflicts of interest will often not be applicable – art. 523 CC requires a meeting of the board of directors to be applicable, and directors profiting from corporate opportunities will most likely not inform the board of their (suggested) actions – authors have tried to construe a framework for corporate opportunities that is based on the general duty of loyalty: this duty, derived from the duty to act in good faith, would imply that a director, when confronted with a corporate opportunity (defined in line with tests developed by Anglo-Saxon legal systems, e.g. the business line test) *qualitate qua*, notifies the board of this opportunity[65] or allows the company to usurp the opportunity first.[66] Breach of this duty is sanctioned through liability for managerial errors (art. 527 CC). Case law has not yet clarified the exact scope of this doctrine.

Some authors add that the corporate opportunity might be considered to constitute an "asset," as a result of which the "abuse of company assets" prohibition applies, which is sanctioned through penal law (*infra*).

Finally, art. 524 § 7 CC does deal with corporate opportunities existing between companies and their subsidiaries: a listed subsidiary needs to document, in its annual report, which corporate opportunities have been usurped by its parent company, but concrete examples in practice remain rare, if not non-existent. Decisions of parent companies (via the general meeting or board of directors) to refer certain opportunities to only one subsidiary could potentially be annulled on grounds of abuse of majority position.[67]

4.3.5 Co-existence of liability

It is also possible for there to be a co-existence of liability where, for example, a director commits a fault in the exercise of his management and simultaneously breaches the general duty of care. He would then be liable, respectively, to the company and a third party. In the famous UNAC case, it was held that continuing an obviously insolvent enterprise (comparable to "wrongful trading" – see *infra*

[65] D. WILLERMAIN, "Les 'corporate opportunities' (notamment au sein des groupes de sociétés)", *TBH* 2005, 468-469.
[66] H. DE WULF, *Taak en loyauteitsplicht van het bestuur van de naamloze vennootschap*, Antwerpen/Groningen, Intersentia, 2003, 775; P. ERNST, "Misbruik van vennootschapsgoederen'. Enkele bedenkingen vanuit het vennootschapsrecht bij de introductie van een nieuw misdrijf in het rechtspersonenrecht", *TRV* 1998, 80; H. SEELDRAYERS, "Art. 492*bis* Sw.: het paard van Troje voor een efficiënt gesanctioneerde 'corporate opportunity doctrine' naar Belgisch recht?", *TRV* 1998,314-315.
[67] Comp. Antwerpen 22 mei 2003, TRV 2005, 489, noot H. De Wulf, which, however, decided not to annul the involved general meeting decision.

section 5) in circumstances where it is clear that the company will only accumulate additional losses without a serious chance of recovery, is both a fault in the exercise of the company's management and a breach of the general duty of care owed to all affected parties and to the company's creditors in particular.[68] There are divergent views as to when exactly a fault in the exercise of management also amounts to a breach of the general duty of care, which is why some academics warn against an improper conflation of both types of fault.[69]

4.4 Exemptions and limitations

The "margin of appreciation" -test, the fact that breaches of obligations of means have to be proven by the party alleging the breach, and the potential waiver of claims constitute the basis of protection for directors when faced with a liability action.

While it is also possible under Belgian law for a director to enter into an indemnity agreement with the company, in practice most liability claims will be made upon insolvency, in which case the director's indemnity is as valuable as any other claim by an unsecured creditor. In any event, by entering into an indemnity agreement, the company does not relinquish its right to enforce a claim against the director, which would be qualified as an exclusion of liability.

Whether exclusion clauses are valid is a difficult question. The authors who argue against their validity point out that the rules on liability are imperative, which means that the company cannot renounce its right to bring a liability claim before the damage or loss has occurred.[70] Others argue that such clauses are valid, provided that the general meeting has approved the clause and the clause does not erode the essence of the director's agreement.[71] In any event, any exclusion clause would not affect the external liability of a director. With respect to provisions in the articles of association, case law confirms that third parties may not be prejudiced by provisions which prescribe that directors are not personally bound by the obligations of the legal person (in this case a non-profit), especially as regards the consequences of agency for third parties.[72]

Finally, as regards ex ante approval, there is case law stating that directors are not liable when merely executing general meeting decisions. However, this does not free them from having to comply with the Companies Code and the articles of association and does not constitute a ratification of other managerial errors. Directors are thus not exempted by just referring to the execution of general meeting decisions.[73]

[68] Commercial Court of Charleroi, 12 October 1976 [1976] Revue Pratique des Sociétés, 143.
[69] J.-M. Nelissen Grade, *Vennootschapsrecht – Capita Selecta* (Leuven 2008-2009), 35.
[70] D. Van Gerven, 'Les clauses limitatives de responsabilité, les garanties d'indemnisation et l'assurance responsabilité civiles des mandataires sociaux' [1998] Revue Pratique des Sociétés, 147.
[71] J. Ronse, J.-M. Nelissen Grade, K. Van Hulle, J. Lievens en H. Laga, 'Vennootschappen – Overzicht van rechtspraak (1978-1985)' [1986] Tijdschrift voor Privaatrecht, 1234.
[72] Labour Court of Ghent, 13 December 2004 [2007] Tijdschrift voor Rechtspersoon en Vennootschap, 145.
[73] Antwerp 2 March 2006,*TRV* 2007, 192.

4.5 Insurance against liability

Pursuant to art. 8 of the Law on Non-marine Insurance Agreements, a director can be insured against contractual liability, even for serious errors or criminal acts. Only serious errors expressly listed in the agreement are not insured. The director himself or the company can take out the insurance. The company can even insure a director against external liability. It is argued that such insurance is in the corporate interest, since a director who is overly risk-averse for fear of liability may paralyse a business.[74]

4.6 Consequences of liability

As for consequences of liability, reference is made to the discussion of various remedies that can be brought in response to harmful board decisions or acts (*infra*, on annulment/suspension and liability claims).

4.7 Duration of liability

Provided that the director does not resign at a moment that is harmful to the company, he is in principle entitled to resign at any time without incurring liability. As against the company, resignation, termination by the company, or expiration of the mandate will have immediate effect, irrespective of the date of publication of the resignation. The director will remain accountable to the company for acts or omissions that occurred during his mandate, even if the loss occurs after the end of the mandate, but he will not be liable for wrongful acts or omissions that occur after the end of his mandate. It must be stressed, however, that a director remains in office for a reasonable time (after his resignation) if the company has not been able to replace him and that he will remain liable for his actions and omissions during that period. After a reasonable period of time is given to the company to organise his replacement, the director is freed from this liability.[75]

Unless they have actual knowledge of the circumstances, a director's resignation or termination by the company can only be held against third parties as of the publication in the annex of the Belgian Official Gazette (art. 76 CC). For example, until he has been replaced, a director cannot justify his lack of involvement in relation to third parties by sole reason of his resignation.[76] The Court of Appeal of Brussels has held that until such replacement, a director has the duty to declare bankruptcy if the conditions thereof are satisfied.[77] The requirement of publication will not be necessary in the event of the expiration of the mandate, provided the duration of the director's mandate is expressed in the founding documents of the company or in the published instrument of appointment. In this case, opposability to third parties has effect without additional formalities.

[74] M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders* (Intersentia 2009), 29-30.
[75] K. Geens, M. Wyckaert, C. Clottens, F. Parrein, S. De Dier and S. Cools, w.c.o. F. Jenné and A. Steeno,'Overzicht van rechtspraak 1999-2010', *TPR* 2012, 292-293.
[76] Y. De Cordt and M.A. Delvaux, 'La responsabilité des dirigeants en droit des sociétés et en droit financier' in Y. De Cordt and D. Philippe (eds.), *La responsabilité des dirigeants de personnes morales* (Die Keure 2007) 20.
[77] Court of Appeal of Brussels, 24 February 2000 [2002] Recueil annuel de jurisprudence en droit des sociétés commerciales, 191.

As regards internal liability, the general meeting decides each year, by ordinary resolution, whether to acquit the directors. Such acquittal constitutes a waiver of the GM's right to bring proceedings for liability on behalf of the company (*action mandati*). This acquittal is only valid when the annual accounts contain no omissions or errors. Acquittal does not affect external liability of directors (towards third parties and individual shareholders), nor does it impede the shareholders' right to launch a derivative action (as long as they have not voted in favour of the acquittal; *infra*).

In any event, any claim against a director will be time-barred if it is made after the limitation period of five years after the act took place or, if it has been intentionally hidden, five years after it was discovered (art. 198, §1, 4th indent CC).

5 Duties in the Vicinity of Insolvency

Claims for pre-insolvency liability against *de iure* and *de facto* directors tie all the above principles and grounds of liability together. There is no special liability regime for these claims, so they will have to be brought under contract, tort, and the special company law liability provisions. The main focus of this section will be the alternative liability for continuing an obviously bankrupt enterprise. The relation between these two types of liability is not always clear, although it is likely that the latter will be used to hold a director liable in the event that the company ceased to pay its debts more than six months prior to the date when the court declares the company bankrupt. This is due to the fact that cessation of payment (a condition for declaring a company bankrupt – art. 2 Bankruptcy Act 1997) is deemed to occur on the date of the bankruptcy declaration or, if objective circumstances unequivocally indicate that cessation of payment occurred earlier, an earlier date, provided that this is not more than six months before judgment (art. 12 Bankruptcy Act 1997).[78]

5.1 The meaning of 'vicinity of insolvency'

To begin with, continuing an obviously insolvent enterprise will constitute a fault when there are no reasonable chances of recovery.[79] The courts have to exercise restraint in assessing whether the company is beyond salvation (*cf*. "margin of appreciation"-test, *supra* section 4).[80] It was already pointed out that in the famous UNAC case it was held that, where it is clear that the company will only accumulate additional losses without a serious chance of recovery, this is both a fault in the exercise of a director's management (managerial error; art. 527 CC) and a breach of his general duty of care owed to any affected party and to the company's creditors in particular (art. 1382 Civil Code).[81] In

[78] K. Geens, 'Overzicht van rechtspraak. Vennootschappen 1992-1998' [2000] Tijdschrift voor Privaatrecht, 317; M. Wyckaert and F. Parrein, 'Een ongeluk komt nooit alleen. Hoe weegt de insolventie van de vennootschap op de bestuurdersaansprakelijkheid?'[2011-2012] Themis cahier, 25.
[79] Court of Appeal of Antwerp, 8 March 1994 [1995] Tijdschrift voor Rechtspersoon en Vennootschap, 500.
[80] *Cf.* Court of Appeal of Antwerp, 8 March 1994 [1995] Tijdschrift voor Belgisch Handelsrecht, 37 ; Court of Appeal of Ghent, 7 June 2001 [2003] Recueil annuel de jurisprudence en droit des sociétés commerciales, 217.
[81] Commercial Court of Charleroi, 12 October 1976 [1976] Revue Pratique des Sociétés, 143.

certain circumstances, although not automatically,[82] this fault will be an obviously serious fault contributing to the bankruptcy, if bankruptcy is eventually declared (art. 530 CC).[83] Additionally, when a director enters into a transaction while this was no longer reasonably justifiable in light of the impending bankruptcy, he commits a pre-contractual fault (*culpa in contrahendo*) for which he will be liable in tort (art. 1382 Civil Code) (*supra* section 4.1.1.).

5.2 Change of existing duties

While there is significant academic opinion in favour of including the interests of the creditors in the corporate interest when the company is in financial difficulty,[84] there is also outstanding uncertainty as there is no statutory acknowledgement that creditor interests should be taken into account.[85] Notwithstanding this debate, it has already been noted that directors can be held liable when continuing an obviously insolvent company and thereby damaging creditors' interests. While the precise limits of this liability are still unclear,[86] it does constitute an alteration of the liability for managerial errors (art. 527 CC) and for breaches of the general duty of care (art. 1382 Civil Code) to the benefit of the creditors. However, art. 527 CC is only enforceable by the company or by the trustee representing it in insolvency proceedings; creditors do not receive separate standing in the vicinity of insolvency. Moreover, art. 1382 Civil Code will seldom be enforceable by creditors when directors can be regarded to perform contractual obligations of the company, as directors are protected by the "quasi-immunity" outlined above.

5.3 Newly arising duties

Like the late declaration of bankruptcy,[87] continuing an obviously insolvent enterprise does not constitute a breach of the CC or the articles of association, so there will be no joint and several liability on this basis alone (*cf.* art. 528 CC). However, the courts can impose joint and several liability or *in solidum* liability for common and concurrent managerial errors respectively (*supra* section 1.3.; art. 527 CC), something which the courts are likely to do since all directors are deemed to be aware of the financial situation of the company.[88] Also, it is possible that there will be accompanying breaches which violate the CC or the articles and could thus trigger the joint and several liability of art. 528 CC, for example failing to call the general assembly within two months after it ought to have been established that the company's net assets have fallen below half of the company's registered capital (art. 633 CC, *supra* section 4.3.2.).

[82] Court of Appeal of Liege, 13 January 2004 [2005] Le Droit des Affaires – Het Ondernemingsrecht, 52.
[83] Court of Appeal of Ghent, 21 December 2000 [2001] Tijdschrift voor Belgisch Handelsrecht, 739.
[84] I. Corbisier "Pour une nouvelle dimension contractuelle et une personnalité morale nonobligatoire en droit des sociétés", Rapport aux XIVèmes Journées d'études juridiques Jean Dabin, Louvain-la-Neuve,UCL,1992,p.15,nr.9 ; M. Delierneux enY. Stempnierwsky, "Le banquier et l'entreprise en difficulté: quelques réflexions relatives à la restructuration de la dette et à la renégociation des contrats",inMélanges Jean Pardon,Brussel,Bruylant,1996,p.225-227.
[85] A. François, *Het vennootschapsbelang*, Antwerpen, Intersentia, 1999, 438.
[86] M. Wyckaert and F. Parrein, 'Een ongeluk komt nooit alleen. Hoe weegt de insolventie van de vennootschap op de bestuurdersaansprakelijkheid?'[2011-2012] Themis cahier, 20ff.
[87] The obligation stems from art. 9 Bankruptcy Act 1997.
[88] M. Wyckaert and F. Parrein, 'Een ongeluk komt nooit alleen. Hoe weegt de insolventie van de vennootschap op de bestuurdersaansprakelijkheid?'[2011-2012] Themis cahier, 27.

6 ENFORCEMENT OF DUTIES

6.1 Distinguishing annulment/suspension claims from liability claims

Belgian law allows for both annulment/suspension claims and liability claims. This distinction is crucial to an understanding of the enforcement possibilities.

The **first type** of claims imply that "*any interested party*" can challenge company decisions by requesting the annulment or suspension thereof (art. 64, 178-180 CC); such claims are brought against the company as a defendant. Although art. 64 CC is in wording limited to general meeting decisions, courts have applied this section to board decisions as well, given the fact that art. 64 CC stems from a general approach developed by case law for all types of company decision. These claims can be brought by all interested parties, as long as the general rules of civil procedure are met. Art. 17-18 Civil Procedure Rules demand any person bringing a claim before a civil court to show an (personal) actual, legitimate and immediate interest, meaning that there is some personal advantage to be gained from demanding that a certain cause of harm be removed.

As for (minority[89]) shareholders, courts are quite accommodating with respect to the admissibility of claims. Generally, shareholders will not have to put much effort into showing that the requested measure aims to avoid harm caused by a decision.[90] Moreover, the mere fact that they hold shares often seems sufficient for them to be allowed to continue the claim,[91] provided that shareholder rights have been infringed.[92] They may, however, be denied standing when they have acquitted the directors at several general meetings.[93] No distinction is made between cases where these shareholder rights are personal and where they are derived from the relationship between a company and its directors. Shareholders could thus use art. 178 CC to enforce a breach of duty by the board of directors – given that case law is scarce, it remains to be seen what a court will do with a claim brought by a shareholder with only a very small claim. Finally, the terminology would allow shareholders to enforce stakeholder interests, as long as the claim does not constitute an *actio popularis*.

There have been very few (reported) cases of third parties attempting to challenge board decisions pursuant to art. 178 CC. From case law involving general meeting decisions, it can be inferred that third parties are rarely allowed to do so, and certainly not when they invoke mere formal irregularities in the decision-making process.[94] This traditional reluctance towards third party actions has been confirmed as regards board decisions.[95]

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89 Although exceptional, a majority shareholder can also have an interest in challenging a board decision that is liable to pushing him aside: Brussels 20-Dec-1995, *TRV* 1996, 54.

90 See Comm. (réf.) Brussels 18-Nov-2008, *TRV* 2008, 699; Comm. (réf.) Brussels 18-Nov-2008, *TRV* 2008, 688; Brussels 12-Dec-2008, n131, no. 57; Comm. Antwerp 8-Jan-2010, n138; Brussels 20-Dec-1995, *TRV* 1996, 54; Comm. Brussels 25-Sep-1987, *RPS* 1988, 165.

91 Brussels 4-May-2000, *RPS* 2001, 84, no. 7 ('*en cette seule qualité, il a un intérêt direct et personnel, né et actuel […] à contester en justice, par voie de suspension ou d'annulation, les décisions prises par les organes de la société en violation de la loi ou des statuts*'). Similarly: Comm. (réf.) Brussels 7-Sep-2000, *TRV* 2000, 375; Comm. (réf.) Antwerp 10-Sep-1997, *V&F* 1997, 322; Comm. Brussels 27-Apr-1978, *RPS* 1978, 276.

92 Brussels 30-Jun-2010, *Jur.Falc.* 2010-11, no. 8; Comm. Brussels 8-Dec-2009, *TRV* 2010, 58, no. 7.

93 Comm. (réf.) Liège 3-May-1996, *JLMB* 1996, 809.

94 Cass. 5-Jul-1878, *Pas*. 1878, I, 300.

95 Comm. Liège 17-Oct-2003, *RDC* 2005, 429.

Belgian civil law traditionally provides creditors with the possibility to bring an indirect action (art. 1166 CC; "*action oblique*"), thereby exercising the rights of the debtor in case the latter fails to do so. Creditors might thus indirectly ask for annulment/suspension, but no such claims have been reported as regards board decisions.

Finally, when the conflicts of interest regime applies (art. 523/524/524*ter* CC), only the company can file for annulment of the conflicted decision or transaction, to the exclusion of (minority) shareholders and third parties (*supra*).

The **second type** of claims (liability claims: art. 527-530 CC) are pecuniary claims, meaning that claimants can only receive damages in case of a successful application; these claims are brought against directors *ut singuli* as defendants. This type of claim is further developed in the following paragraphs.

6.2 Who has standing to sue

6.2.1 The company as plaintiff

The general assembly (or the trustee in bankruptcy in his capacity as representative of the company) has exclusive authority to bring a liability claim for corporate harm against a director, called the "company action" or "*actio mandati*". When the decision is made by simple majority to bring a claim, the board of directors or a specially appointed agent will represent the company in the proceedings (art. 561 CC). This power goes hand in hand with the general assembly's exclusive power to acquit directors, whereby, provided no misrepresentations as to the state of the company were made, the company waives its right to bring a claim (art. 554 CC). Such acquittal also bars a trustee in bankruptcy from bringing an "*actio mandati"* during bankruptcy. However, it does not have any third-party effects – unless they exercise the *actio mandati* indirectly (pursuant to art. 1166 Civil Code) – including when the trustee in bankruptcy acts on behalf of the joint creditors for collectively suffered losses, for in this case he will be claiming as a third party.

Any claim against a director will be time-barred if it is made after the limitation period of five years after the act took place or if it has been intentionally hidden five years after it has been discovered (art. 198, §1, 4th indent CC).

6.2.2 The shareholders as plaintiffs

6.2.2.1 In their own name

An individual shareholder will only have a personal claim (i.e. brought on his own behalf) against a director if he can prove to have suffered a loss distinct from the loss suffered by all the shareholders proportionally as a result of the decrease in the company's assets or the increase of liabilities. An example is the decision of a shareholder, based on incorrect accounts, to purchase shares at a price that is too high.[96]

6.2.2.2 In the name of the company ('derivative action')

Under certain conditions the company action can be brought by a minority of shareholders pursuant to the rules of a "minority action" (art. 562 CC). This claim is distinct from a claim by individual shareholders in that it is brought on behalf of the company and thus demands recovery of corporate loss. However, the minority action has proven unpopular because any proceeds of the claim are due to the company, while the minority shareholders have to advance litigation costs. In case of a successful claim, judgement is given in favour of the company, without direct personal benefit to the claimant, and the claimant is reimbursed with respect to litigation costs. When the claim is not successful, claimants can be condemned to pay all outstanding litigation costs (and in some events complementary damages; art. 567 CC).

For a minority action to be admissible, the following conditions have to be satisfied:

(i) the shareholders bringing the action must hold securities that represent at least 1% of the votes; or

(ii) hold securities representing a part of the capital of at least EUR 1,250,000.00; and

(iii) the shareholders with voting rights must not have voted in favour of the acquittal of the directors.

6.2.3 Third parties

Liability for breaches of the Companies Code and articles of association (art. 528 CC) can be enforced both by the company and third parties, including individual shareholders if they prove to have suffered a loss distinct from the loss suffered by all the shareholders proportionally as a result of the decrease in the company's assets or the increase of liabilities. Third parties can also enforce the general duty of care (art. 1382 Civil Code), provided that they prove fault, damage and causation, and are able to overcome the 'quasi-immunity' of the director who executes a contractual obligation on behalf of the company.

6.2.4 Bankruptcy claims

Special rules as to who can bring a claim apply during bankruptcy. Claims for collectively suffered losses will be brought by the trustee in bankruptcy. Individuals are barred from bringing claims for collectively suffered losses after the onset of bankruptcy.[97] An exception to this rule is the third party's personal right to bring a claim for his proportionate share in the collective loss that resulted from a

[96] K. Geens and J. Vananroye, 'Burgerrechtelijke en strafrechtelijke aansprakelijkheid in de vennootschappelijke context, met inbegrip van het misbruik van vennootschapsgoederen' [2001-2002] Themis Cahier 5, 14.
[97] Supreme Court, 17 January 2008 [2008] Pasicrisie, 130.

director's "obviously serious fault that contributed to the state of bankruptcy" (art. 530 CC). The reason for this exception is that, in practice, trustees in bankruptcy appeared reluctant to bring this claim.[98] Several cases that deal with this enforcement right have already been reported.[99] In a response to continued demand for coherence in enforcement rights, the Belgian Supreme Court has interpreted this individual

6.3 Criminal and administrative sanctions

Although criminal law is beyond the scope of this report, it should be mentioned that the CC contains a number of provisions that attach criminal penalties to breaches of the CC, in addition to the civil liability rule in art. 528 CC.

Furthermore, the Bankruptcy Act 1997 inserted art. 492*bis* into the Penal Code, which sets out criminal penalties for "abuse of company assets" by *de iure* and *de facto* directors. As an additional punishment, the court may strip a person committing this offence of his right to become a director (art. 1 of Royal Decree nr. 22 of 24 October 1934).

Directors may also be disqualified. Pursuant to art. 3*bis* § 2 of Royal Decree nr. 22 of 24 October 1934, the judge declaring bankruptcy may disqualify a *de iure* or *de facto* director as a safety measure in the event that the director contributed to the bankruptcy as a result of his obviously serious fault (art. 530 CC), which would prevent him from performing any trading activity. Additionally, the court may deprive such a person of the right to take up a position as director or officer of a company (art. 3*bis* § 3). Such a ban will not last for more than ten years (art. 3*bis* § 4).

[98] M. Wyckaert and F. Parrein, 'Een ongeluk komt nooit alleen. Hoe weegt de insolventie van de vennootschap op de bestuurdersaansprakelijkheid?'[2011-2012] Themis cahier, 17-18.
[99] For an overview: K. Geens, M. Wyckaert, C. Clottens, F. Parrein, S. De Dier and S. Cools, w.c.o. F. Jenné and A. Steeno,'Overzicht van rechtspraak 1999-2010', *TPR* 2012, 334-335.

7 CONFLICT OF LAWS

In principle, the liability of directors in respect of breaches of company law or the articles of association is governed by the law applicable to the company or *lex societatis* (art. 111, 9° Belgian Private International Law Code of 2004 ("**PILC**"). The *lex societatis* is the law of the state where the company's principal establishment is situated, unless the foreign law refers to the law of the state pursuant to which the company was formed (art. 110 PILC). The Belgian legislator has retained this real seat doctrine after the ECJ's case law involving freedom of establishment in order to ward off potential abuses – the PILC was only adopted in 2004. Belgium is thus formally still a real seat state. In practice, however, courts will have to take the European case law into account. This means that they cannot oblige foreign (European) companies to adhere to Belgian company law once they are validly formed in another Member State. In this respect, no case law has been reported yet.

Given that both the Rome I and II Regulations exclude liabilities arising in companies from their respective scope of application, the *lex societatis* thus governs managerial errors and breaches of the CC and articles of association, including liability towards third parties (art. 527-528 CC).[100] The parliamentary memorandum leaves some doubts in this respect[101] but is to be disregarded since the Regulations are clear.

The principle of *lex societatis* does not apply to breaches of the general duty of care (art. 1382 Civil Code), which are governed by the *lex loci delicti*. In addition, according to the Insolvency Regulation,[102] insolvencies are regulated by the law of the Member State where the bankrupt entity has its centre of main interest (*lex concursus*). Hence, it has been argued that liability for obviously serious errors contributing to the state of bankruptcy pursuant to art. 530 CC is governed by the *lex concursus*.[103] There is no case law to confirm this position.

The answer to the question which law is applicable to liability for late declaration of bankruptcy or for unreasonable continuation of an obviously insolvent company (wrongful trading) is problematic. It seems the majority of academic opinion is inclined towards the *lex concursus*.[104] Concretely, this means that the liability of a director for wrongful trading in respect of an English limited company with its centre of main interest in Belgium will be assessed according to the Belgian rules, instead of s. 214 of the English Insolvency Act 1986.[105]

[100] See Art. 1.2.d) of Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations and Art. 1.2.f) of Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations.
[101] Parliamentary proceedings Senate 2003-04, nr. 3-27/7, 205-206.
[102] Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings.
[103] H. De Wulf and L. Van den Steen, 'Enkele IPR-problemen uit het economisch recht: het mogelijke conflict tussen *lex concursus* en *lex* societatis, de effecten op rekening, en Europees getinte class actions in de VS', in J. Erauw and P. Taelman (eds.) *Nieuw internationaal privaatrecht: meer Europees, meer globaal* (Kluwer 2009), 451; V. Simonart, 'L'application du droit belge aux societiés constituées dans un autre Etat de la Communauté et, en particulier, aux limited' [2008] Revue Pratique des Sociétés, 187-188.
[104] H. De Wulf and L. Van den Steen, 'Enkele IPR-problemen uit het economisch recht: het mogelijke conflict tussen *lex concursus* en *lex* societatis, de effecten op rekening, en Europees getinte class actions in de VS', in J. Erauw and P. Taelman (eds.) *Nieuw internationaal privaatrecht: meer Europees, meer globaal* (Kluwer 2009), 454-455.
[105] M. Wyckaert and F. Parrein, 'Een ongeluk komt nooit alleen. Hoe weegt de insolventie van de vennootschap op de bestuurdersaansprakelijkheid?'[2011-2012] Themis cahier, 21.

Directors' Duties and Liability in Bulgaria

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LSE Enterprise

CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in Bulgaria

Company Law in Bulgaria is based on statute law. The Commercial Act,[1] enacted in 1991 with its subsequent amendments, is the primary source of company law. It has the significance of a code, due to the fact that it provides a system of the most important topics of commercial law.[2] The main source of company law and commercial law is the statute law. Case law is not recognised as a source of the Bulgarian company and commercial law. The Bulgarian Judiciary system act (s. 124) also does not lead to the opposite conclusion.[3]

The Constitution of the Republic of Bulgaria is the supreme legislative act and contains general provisions such as s. 19, subs 4[4] regarding the right of free cooperation and consociation of individuals and legal entities for the achievement of economic and social prosperity. This provision establishes the constitutional ground for company law and the law of cooperative societies.[5]

The Commercial Act is of major significance and applies to any Bulgarian company, whether privately held or listed on the stock exchange. This statute regulates all general issues regarding the company e.g. incorporation, rights and obligations of the shareholders, corporate capacity, relations vis-à-vis the shareholders, vis-à-vis shareholders and the company, and vis-à-vis the board and the company. It also governs the power of the general meeting and the boards, the organisational structure of the company, procedures regarding the convention of the annual and extraordinary general meetings, the transformation of the company, its liquidation and insolvency.

Chapter 10 governs the incorporation of a company and applies with no exception to all types of corporate entities. Chapter 14 "Shareholders' Company" contains detailed regulations regarding companies, which are very similar to the "*Aktiengesellschaft*" in Germany. The Bulgarian national term for such type of companies is "shareholders' company". In Bulgaria the term "public company" means a company, established under the conditions of the Public Offering of Securities Act. The provisions, concerning the shareholders' companies are also applicable to the Bulgarian public companies, unless there are mandatory provisions in the Public Offering of Securities Act which prevail.

The Public Offering of Securities Act provides criteria for determination of a public company and specific rules and requirements for management and corporate governance of the public company.

[1] The Commercial Act, Prom. SG. 48/18 Jun 1991, amended subsequently, last amendment SG. 60/7 August 2012.
[2] Angel Kalaidjiev *Commercial Law* (1st edn, IK Trud i pravo 2010) 28.
[3] S. 124 (1) In presence of contradictory or erroneous jurisprudence on the interpretation or application of the law, an interpretative judgement shall be adopted by the general assembly of:
1. The criminal, the civil or the commercial college of the Supreme Court of Cassation,
2. The civil or the commercial colleges of the Supreme Court of Cassation,
3. A college of the Supreme Administrative Court,
4. The colleges of the Supreme Administrative Court.
(2) In presence of contradictory or erroneous jurisprudence between the Supreme Court of Cassation and the Supreme Administrative Court, the general assembly of the judges of the respective colleges of the two courts shall adopt a joint interpretative decree.
[4] The Constitution of the Republic of Bulgaria, s. 19, subs 4: The law shall establish conditions conducive to the setting up of cooperatives and other forms of association of citizens and corporate entities in the pursuit of economic and social prosperity.
[5] Kalaidjiev (n 2) 27.

The special provisions of the Public Offering of Securities Act exclude the application of the general provisions of the Commercial Act. Pursuant to section 121 of the Public Offering of Securities Act the Commercial Act applies only for issues not governed by this act.

There are several sector-related acts which provide additional specific requirements for the management of shareholders' companies, operating in particular business sectors, such as banks and credit institutions,[6] insurance companies,[7] public companies,[8] special investment companies[9], etc.

Furthermore, sources of company law are subordinate legislative acts such as decrees of the Council of Ministers by virtue of which different regulations (rule books) are enacted.[10] Decrees of ministers also are issued and govern relevant matters in state-owned companies.[11]

Relevant provisions of the general Bulgarian private law apply as subsidiary rules where there are not specific rules of the Commercial Act.[12]

In addition to the aforementioned regulatory sources, *National Code for Corporate Governance* was presented in 2007. The Code is, by its nature, a standard of good practice. It provides companies with a framework for corporate management and control[13] The Code applies to public companies according to the "comply or explain" principle. In October, 2007 it was adopted by the board of directors of the Bulgarian Stock Exchange – Sofia ("BSE – Sofia"). According to BSE - Sofia Rules and Regulations, issuers willing to be admitted to trading on the Official Market of Equities, Segments "A" and "B", are obliged to carry out their activity in accordance with the National Code for Corporate Governance, approved by BSE – Sofia. Adoption and implementation of the Code by the companies with shares, traded on other markets and market segments, or unlisted companies, is voluntary and recommended.[14]

In addition to the aforementioned statute, provisions and subordinate legislative acts are a company's by-laws. By-laws comprise the Articles of Associations (company's statute) and any internal instruments which establish the specific rules, procedures and criteria for the functioning and management of the company.

The content of the statute of the shareholders' company is described in s. 165 of the Commercial Act and consists of provisions regarding the scope of business activity of the company, the amount of capital, types of shares and specific rights for particular class of shares, if any, the board structure (one-tier or two-tier) etc. It is published in the company registrar. The by-laws clauses shall be in accordance with the mandatory provisions of the Commercial Act and other relevant statutes, but they can differ from the optional provisions of the Commercial Act and relevant legislation.

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[6] Law of Credit Institutions ss 11, 12.
[7] Insurance Code ss 13, 14.
[8] Public Offering of Securities Act s 116a.
[9] Law of Special Investment Companies s 8.
[10] Decree 112/23.05.2003 for enactment of Regulation for the order of enjoyment of rights of the state in companies with state participation of the capital.
[11] Kalaidjiev (n 2) 31.
[12] "In particular, regarding the obligations owed by the directors to the company, the provisions of Obligations and Contracts Act ss 280 – 292 which govern the mandate apply.
[13] Alexander Katzarsky, *The International Comparative Legal Guide to: Corporate Governance 2011, p 37* www.iclg.co.uk.
[14] See The National Code for Corporate Governance, 2007, Preamble.

The management board, the supervisory board and the board of directors may adopt detailed rules and procedures for its operation.

1.2 Corporate landscape in Bulgaria

The Bulgarian Company law provides the following types of companies governed by the Commercial Act: registered partnership (chapter XI), private limited partnership (chapter XII), limited liability company (chapter XIII), shareholders' company (chapter XIV), partnership limited by shares (chapter XV). The cooperative societies (cooperatives) are governed by the Cooperative Societies Act.

According to the official statistics, available on the website of the Bulgarian Company Registrar,[15] there are 11 292 shareholders' companies registered, with 674 of them being struck off from the Company Registrar. Thus in total 10 618 shareholders' companies are active and conduct business activity. Among them 2059 are single member shareholder's companies, 466 are public companies,[16] 71 are special investment purposes companies. There are 7841 with a one-tier board structure, while the remaining companies are with a two-tier board structure.

The state-owned companies are governed by provisions of the Commercial Act and subordinate legislation. Section 61 stipulates:

A state-owned and municipal enterprise shall be either a single member limited liability company or a single member shareholders' company. State-owned and municipal enterprises may also form other companies or groups of companies.

According to the provision of section 62 of the Commercial Act the state-owned enterprises shall be formed as or transformed into single member limited liability companies or single member shareholders' companies pursuant to a procedure to be established by a statute, while the municipal enterprises - by virtue of resolution of the municipal council.

The incorporation and the transformation of the state-owned companies as well as corporate governance issues are provided in the regulation for the order of enjoyment of rights of the state in companies with state participation of the capital.[17] Due to the state ownership, severe restrictions are established on the management and asset disposal in order to ensure the reasonable protection of the interests of the state as shareholder in the state-owned shareholders' companies.

1.3 The board of a Bulgarian shareholders' company

The Commercial Act provides the opportunity for the promoters or, after the incorporation of the shareholders' company, for the shareholders, to choose between a one-tier and two-tier board structure. There are not any mandatory restrictions in the Commercial Act on the right to choose each of them, including to change or to replace the one-tier board structure with two-tier and vice-versa.[18]

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15 www.brra.bg
16 www.fsc.bg
17 Ognian Gerdjikov and others *Commentary on the Commercial Act. Volume 1* (Sofi – R 2007) 318.
18 Vitali Tadjer and others, *Capital Companies* (IK Trud I pravo 2011) 191.

Chapter 14 "The Shareholders' company", Division IX, Sub–division II contains general provisions for both board structures such as tenure of office,[19] eligibility,[20] rights and obligations,[21] due care,[22] liability and required guarantees,[23] related-party transaction rules,[24] special requirements for transactions above a certain threshold[25], etc. As a mandatory rule, in section 237 (1) it is stated that the members of the boards have equal rights and obligations, regardless of any internal division of functions among them and the conferring of right of management and representation right on some of them.

The *two-tier system* is governed by sub-division III of division IX, chapter 14 of the Commercial Act. According to section 241(1) the shareholders' company shall be managed by a management board which shall act under the control of a supervisory board. The members of the management board are appointed and dismissed by the supervisory board, which shall determine their remuneration and shall have the right to dismiss them at any moment.[26] The management board consists of a minimum of three and a maximum of nine members and this number should be determined in the company's statute.[27]

The functions and structure of the supervisory board are provided in sections 242 and 243 of the Commercial Act. The supervisory board cannot participate in the management of the company. It represents the company only vis-à-vis the management board. The supervisory board consists of a minimum of three to a maximum of seven members, appointed and removed by the general meeting of the company.

The one-tier board structure is governed in sub-division IV of division IX, chapter 14 of the Commercial Act. Section 244 (1) stipulates that the shareholders' company is managed and represented by the board of directors with three to nine members. The members of the board of directors are appointed and removed by the general meeting. They elect among them a chairman, a vice-chairman, and one or more executive members who are in charge with the management of the company. The latter should be less than the non-executive members. By appointment of the executive members the other members of the board are not exempted from their rights and obligation to manage the company, neither from their liability for damages of the company.

As stated above,[28] the Commercial Act applies to all shareholders' companies as a general act, except if mandatory provisions of other acts narrow its application and establish specific additional rules and requirements, regarding the governance of shareholders' companies, such as public companies, insurance companies, special purpose investment companies, etc. Section 116a (2) of the Public Offering of Securities Act and section 13a of the Insurance Code provide that at least one-third of the members of the board of directors or management board of the public company, resp. the insurance company shall be independent members. If an independent member loses his quality of being independent during the term of his office, he is obliged to inform the respective board immediately, he ceases the exercising of his functions as a board's member and stops receiving remuneration (s. 116a (3) Public Offering of Securities Act and 13a (3) Insurance Code). The term

[19] Commercial Act s 233.
[20] Commercial Act s 234.
[21] Commercial Act s-s 236, 237.
[22] Commercial Act s 236 (2).
[23] Commercial Act ss 240, 240 a.
[24] Commercial Act s 240b.
[25] Commercial Act s 236.
[26] Commercial Act s 241 (2).
[27] Commercial Act s 241 (4).
[28] (n 6 – 9).

"independent director" is relatively close in its meaning in the Public Offering of Securities Act and the Insurance Code, but is not the same, and in both acts it is determined negatively, by defining who is not considered an independent director[29].

[29] Nikolay Kolev, *The Terms "independent director" and "unbiased director" under the Bulgarian Company Law* Business Law Journal, issue 1 2010.

2 THE CONCEPT OF 'COMPANY DIRECTOR' IN BULGARIA

2.1 De iure directors

2.1.1 Who can be *de iure* director

Pursuant section 234 of the Commercial Act member of a board (management board, supervision board and board of directors) might be a natural person (individual) with legal capacity and, if the company's statute provides so, a legal entity. When the latter is a member of the board, it should determine an individual to act on its behalf as a board member.

There are certain restrictions on who can become a de iure director as set out in mandatory provisions under s. 234, subsection 2 of the Commercial Act. No person or entity can be appointed board member if such person or entity was a member of the management or controlling body of any company that had entered insolvency within the last two years unless all creditors' claims were fully satisfied in such insolvency procedure. Additional requirements towards the board members may be arranged also in the statute of each company.

Separate acts, arranging specific types of companies, such as public companies, insurance companies, etc. can establish additional requirements, too. For example s. 116a of the Public Offering of Securities Act.[30]

Furthermore, the de iure member of a board (director) can be classified as such when:

- The natural person or legal entity is not disqualified from being a member of a board (director);
- The member of a board (director) has been appointed to the office according to the rules governing this;
- The member of a board (director) has agreed to hold office by submission in the Company Registrar of a notary certified consent and a declaration that there are no obstacles under the aforementioned subsection 2 of s. 234 of the Commercial Act;
- The member of a board (director) is registered as such in the Company Registrar. The inscription of the member of the board in the Company Registrar is an obligatory element for the constitution of the board's member as such (s. 231 (4) Commercial Act).

[30] S. 116a. (1) As members of the management and the control bodies of listed public companies cannot be elected persons, who by the moment of the election are convicted with a sentence entered into force for crimes against the ownership, against the economy or against the financial, the tax and the insurance system, committed in the Republic of Bulgaria or abroad, unless they have been rehabilitated. Access to the acts in English at www.ciela.net.

2.2 De facto and shadow directors

The position of the “de facto and shadow director” is not recognised as such neither by the Bulgarian legislation, nor by the court practice. Although the term “control” is arranged in the Bulgarian legislation, the controller cannot be held liable as a de jure director.

3 THE SCOPE OF DIRECTORS' DUTIES UNDER BULGARIAN LAW

The members of the management board and the supervisory board are obliged to conduct any and all business activities of the shareholders' company. Pursuant section 237, subsection 1 of the Commercial Act, the members of the boards have equal rights and obligations, regardless of any internal division of functions among them and the granting of the right of management and representation to some of them. Subsection 2 of section 237 of the Commercial Act provides that the members of the board are obliged to execute their functions by applying the due care of a diligent merchant for the benefit of the company and all shareholders.

The management is assigned to a board's member with a decision for election of the nominee as a board's member by the company, consent of the nominee to be a board member and inscription of the nominees' name in the Companies Registrar. The board's member obligations, arranged in the Commercial act, become valid from the moment of the inscription in the registrar. The management contract arranges additional obligations, which are not arranged expressly in the Commercial act.

A subject of discussion in Bulgarian theory is the legal nature (character) of the management contract – whether it falls within the scope of the general civil law contracts[31] or within the scope of commercial contracts[32]. It is widely held in both the court practice and academia[33][34] that the legal relation between the public company and each of the directors is *of mandate type* (lat. *mandatum*). It can be said that the management contract is a separate type of civil (obligations) contract, which has its specific origin grounds – election, its own content – obligations for managing the company, for loyalty and due diligence, as well as specific terms for its termination.

The following duties are governed in the Commercial Act:

- Duty to execute their functions as board members with the due diligence;[35]
- Duty of loyalty;
  - Duty to restrain from exercising competition activity unless otherwise stipulated;[36]
  - Duty for non – disclosure (confidentiality);[37]

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[31] For the civil law (obligations) nature of the contract - see Kr. Stoychev, Op.cit, p. 50 and the following. The author, though, puts an accent on the separate (independent) character of the contract between the manager and the company, and defines it not as a mandate relation, but as a legal connection of mandate type, towards which shall not be automatically applied the rules of the classical civil law regulation of mandate contract (p. 53).

[32] For the commercial nature of the contract – see act of the Supreme Court of Cassation Nr. 53/2006 on commercial case Nr. 341/2005, II department – Apis.

[33] Angel Kalaidjiev, *The Public Company* (IK Trud I Pravo 2002) 114, Krasen Stoychev *Companies with registered capital: Management and its legal regulation* (BAN 1992) – both authors consider that the management contract is of mandate type. The fact that this contract *is of mandate type* does not mean that this contract *is a mandate contract* as the one, arranged in the obligations and Contracts Act.

[34] Alexander Katzarsky *The Amendments in the Company Law, enacted on July 1 2003* Business Law Journal issue 4 2003

[35] With the due diligence of the good merchant according to s 237 (2).

[36] Commercial Act s 237 (4).

[37] Commercial Act s 237 (5) The members of the boards shall be obliged not to make public the information having become known to them in their capacity as board members, if this would affect the activity and the development of the company, including after they cease to be members of the board. This obligation does not regard the information which, by virtue of a law, is accessible to third parties or it has already been made public by the company.

As regards listed public company, this duty also exists but within its scope is the " information which is not public", according to the Act on Public Offering of Securities, s 116b, (1) item "c".

- o Duty to disclose to the company facts which might be relevant to their activity as directors (mainly regarding conflict of interests);[38]
- Duty to manage the shareholders' company;[39]

This legal relation consists at least of the right of remuneration, the duty to manage and the duty of loyalty.[40] Namely, the duty of loyalty is the general duty within which fall the following explicitly provided in the Commercial Act duties: duty for disclosure; the duty to restrain from exercising competing activity and the duty to disclose facts and circumstances in order to avoid conflict of interests.

For the purpose of this analysis the aforementioned duties will be regarded as features of the duty of loyalty and as separate obligations but their functions and purpose will be interpreted in the context of their significance as specific duties within the general duty of loyalty. This is expressly accepted in recent case law regarding the duty to restrain from exercising competing activity.[41]

This statement is also supported by the relevant provisions of Public Offering of Securities Act section 116b(1) which is of paramount significance for the regulation of the duties of the directors of public companies:

The members of the management and the control bodies of a shareholders' company are obliged:

1. To fulfil their obligations with the due care of a proper and diligent manager in a way they considered as being in the interest of all the shareholders of the company and using only information they consider reliable and full;
2. To reveal loyalty to the company by:
    a. preferring the interest of the company before their own interest;
    b. avoiding direct or indirect conflicts between their interest and the interest of the company, and if such conflicts occur – timely and fully reveal them in writing before the respective body and do not participate, as well as not render influence over the other members of the council at taking decisions in these cases;
    c. not disseminating not public information about the company also after terminated to be members of the respective bodies, till the public announcement of the respective circumstances by the company.

Evidently, the legal foundation of directors' duties are both the provisions from general private law (regarding the mandate - sections 280 to 292 of the Obligations and Contracts Act) and the listed above specific provisions of the Commercial Act and Public Offering of securities Act, the latter applicable for public companies only. When interpreting the specific rules in these two laws, the courts do so in conjunction with the respective principles of general private law regarding the mandate,[42] as provided in the quoted provisions of the Obligations and Contracts Act.

[38] Commercial Act s 237 (3). In addition, the category of facts and circumstances which has to be disclosed by the directors of listed public company, provided in the Public Offering of Securities Act s. 116b, , is considerably wider than this, subject to disclosure of directors of non-listed public company.
[39] Angel Klaaidjiev (n 26) 115; Vitali Tadjer and others (n 16) 193.
[40] Angel Kalaidjiev and others *Commentary on the Public Offering of Securities Act* (IK Trud I Pravo 2005) 482.
[41] Judgment №66/19.05.2010 on commercial case №832/2009, First Commercial Division (FDV), Supreme Court of Cassation (SCC).
[42] Judgment № 1784/06.11.2001 on civil case № 395/2001 , Fifth Civil Division, SCC.

In addition, a management contract could be entered into with each of the members of the management board; similar contracts can also be entered into with members of the supervisory board. This is an option, not an obligation, but it is frequently used by the shareholders' companies to govern in more detail the rights and duties of the directors.

Even when such a contract is entered into, the express provisions of the Commercial Act determine the respective part of the content of this legal relation and their application could not be excluded with the contract, unless (1) they are optional rules and (2) the derogation from these provisions is provided in the company's statutes or in act or resolution of the respective body of the company, if the Commercial Act allows the latter.[43] If the statute of the shareholders' company or the act or resolution of the company's body does not provide derogation, the contract cannot be in derogation even with the optional rules of the Commercial Act. If its clauses do so, they are void and replaced by the respective provisions of the Commercial Act.[44]

All described duties are applicable cumulatively and enforcement of one of them does not impact claims arising from other duties.

3.1 Types of directors' duties

3.1.1 Duty to execute their functions as board members with the due diligence [45]

Section 237 (2) Commercial Act stipulates that "the members of the boards shall be obliged to perform their functions with the due diligence of a good merchant to the interest of the company and all shareholders." With this provision an objective standard for the duty of care is established.

The due diligence of the good merchant correlates to the duty of care of the proper and diligent manager in the common law jurisdictions but is wider because it is applicable to and owed by all merchants, not solely by the board members. However, within the meaning of this term in section 237(2) of the Commercial Act it refers to the due diligence owed by the proper and diligent manager. This standard is higher than the standard of the due care owed by the ordinary prudent person because it is owed by professionals.

The due care of the proper and diligent manager (in the Commercial Act referred literally as "good merchant") is an abstract and objective measure and it consists of requirements not only for intentional efforts, but also for a certain degree of knowledge, competencies intellectual and physical potential.[46] The efforts and the endeavour are not sufficient. It has to be examined the degree of care of the professional group to which the director belongs: the managers of the shareholders' companies. The due care owed by all the board members is equal[47] by virtue of the rule in section 237 (1) of the Commercial Act which stipulates that the board members have equal rights and obligations.

[43] Alexander Katzarsky (n 43).
[44] Ibid 45.
[45] Commercial Act s 237 (2).
[46] Angel Kalaidjiev, *The Public Company* (IK Trud I Pravo 2002) 118.
[47] Judgment on civil case № 136/2003 from 05.04.2004 of Court of Appeal – Burgas.

According to some authors,[48] the Bulgarian company law regards the duty of care as such with formal, procedural character. When determining the content of this duty, the procedural criterion is used and the formal compliance with the procedures for passing of resolutions and entering into transactions on behalf of the shareholders' company is required. In addition, the prerequisites are established in order to provide requirements for directors to act after objective assessment in order for an informed decision to be taken. Thus, the procedural criterion, as established in the Commercial Act, has objective character which is interlinked with the objective measure for duty of care, because it is based on practice-developed standards for directors and on preliminary determined by the statutes procedures and formal requirements.[49] This author also states that the duty of care doesn't apply to the content of the decision taken or the transaction and its business rationality or whether the decision contributes to the interests of the company and its shareholders, because these factors are relevant for the duty of loyalty.[50]

3.1.2 Duty of loyalty

3.1.2.1 Duty to restrain from exercising competing activity[51]

As part of the general duty of loyalty,[52] the duty to restrain from exercising competing activity aims also to prevent conflict of interests and to ensure that the directors act for the benefit of the company.[53] Section 237(4) Commercial Act stipulates that:

> The members of the board of directors and of the managing board shall not have the right, on their or someone else's behalf, to carry out business transactions, to participate in companies as partners with unlimited liability, as well as to be authorized officers, managers or members of boards of other companies or co-operative societies, carrying out competing activity with respect of the company. This restriction shall not apply if the company's statute explicitly admits so or where the body electing the member of the board has given its explicit consent.

The prohibition comprises:

(1) Carrying out of business transactions (on his behalf or as an agent on behalf of another individual or entity) which are competitive as regards the actual business activity of the shareholders' company;[54]
(2) Participation as shareholder with unlimited liability in another company; or
(3) Participation at the management (as a board member or as authorised officer) of another company or co-operative society,[55] if the actual business activity of these entities is competing to this of the shareholders' company.[56]

[48] Nikolay Kolev *Regarding the Duty of Care of the Members of the board of directors and the management board of the Public Company* Business Law Journal issue 1/2009.
[49] Nikolay Kolev (n 56).
[50] Ibid 58.
[51] Commercial Act s 237 (4).
[52] Judgment №66/19.05.2010 on commercial case №832/2009, First Commercial Division, SCC.
[53] A Kalaidjiev, P Goleva and others *Commentary on the Amendments of the Commercial Act* (IK Trud I Pravo 2003) 98.
[54] Hence, the legal entities as board members are not allowed to carry out competitive activity to the public company, A Katzarsky (n 43) 11.
[55] Within this prohibition falls and the participation in civil partnership due to the fact that this partnership enters into transactions on behalf of or at the expenses of the partners. Ibid 52.
[56] Alexander Katzarsky (n 43) 11.

The provision of section 237 (4) is optional and could be eliminated or expanded by clause in the company's statute. It could also be abolished by the competent body of the company which will pass a resolution for the appointment of the board member (the general meeting for one-tier board structure and the general meeting and the supervisory board for two-tier) to exempt some or all of the board members from this duty. This exemption could be in full or partial, for specific transactions, or for participation in specific companies, other than the shareholders' company, or for a certain period.[57] As mentioned above, this duty is owed until a director is dismissed.

The consequences of the breach of this duty fall within the legal relation between the company and the director only and could result in his dismissal or in liability for losses suffered by the shareholders' company. When a director is simultaneously in breach of his duties to more than one company, he is liable to each of the companies.

3.1.2.2 Duty for non – disclosure (confidentiality)[58]

The Commercial Act Section 237 (5) stipulates:

> *The members of the boards shall be obliged not to make public the information having become known to them in their capacity as members of the board, if this would affect the activity and the development of the company, including after they cease to be members of the board. This obligation does not regard the information which, by virtue of a law, is accessible to third parties, or it has already been made public by the company.*

This duty uses as criterion for its application the effect of the disclosure of the information on the activity and the development of the company. This approach, although narrative, provides with precise criterion regarding the information which falls within its scope and takes into consideration that this information cannot be determined a priori, but depends on certain circumstances which might change[59].

Within the category of the relevant for this duty information does not fall the information, which is significant for the activity and the development of the company but is accessible to third parties by virtue of a law obligation the company to disclose it or by being already announced by the company. But the disclosure done, by a director, doesn't exempt the rest of the directors from their duty for non-disclosure. This duty applies to both individuals and entities who are board members, thus applicable to all individuals who represent the entities in their capacity of directors.

In other laws, apart from the Commercial Act, the scope of this duty is determined by reference to different terms for information subject to non – disclosure. This is done with respect to the specific sector where the statute is applicable[60] or the purposes of the statutes.[61]

[57] Ibid 53.

[58] Commercial Act s 237 (5) The members of the boards shall be obliged not to make public the information having become known to them in their capacity as board members, if this would affect the activity and the development of the company, including after they cease to be members of the board. This obligation does not regard the information which, by virtue of a law, is accessible to third parties or it has already been made public by the company.
As regards listed public company, this duty also exists but within its scope is the " information which is not public", according to the Act on Public Offering of Securities, s 116b, (1) item "c".

[59] Alexander Katzarsky (n43).

[60] Regarding the listed Public company in the Public Offering of Securities Act section 116b (1) item 2 letter c.

[61] E.g. For protection of the competition in the Act on Protection of Competition section 37.

In the Act on Protection of Competition section 37 prohibits disclosure of manufacturing or trade secrets:

1) Prohibited shall be acquisition, usage and disclosure of manufacturing or trade secrets in contradiction to the fair trade practice;
2) Prohibited is the using or divulging of manufacturing or trade secrets when is acquired on condition not to be used or disclosed.

The Supplementary Provisions, para 1, item 9 of the Act on Protection of Competition contains the legal definition of "Manufacturing or trade secrecy":

> Manufacturing or trade secrecy are facts, information, decisions and data connected with the business activity, and keeping in secrecy of which is in the interested of the entitled persons, for which they have taken appropriate measures.

Thus, if the director breaches his duty under the relevant provision of the Act on Protection of Competition, he will be subject to liability under this Act, in addition to his liability under the Commercial Act.

The directors of public companies have a duty for non-disclosure of "information which is not public", pursuant to the Public Offering of Securities Act section 116b (1) item 2 letter "c":

> The members of the management and the control bodies of a public company shall be obliged to … perform loyalty to the company by … not disclosing information, which is not public, about the company also after terminated to be members of the respective bodies, till the public announcement of the respective circumstances by the company.

The term "information which is not public" is not defined in the Public Offering of Securities Act and it is submitted[62] that it means any information which is not subject to a legal disclosure requirement or which is still not disclosed and concerns the public company and securities issued by it. Thus, for directors of public companies, the duty for non-disclosure will be applied according to this wider category information, namely the term "information which is not public".

3.1.2.3 Duty to disclose to the company facts which might be relevant to their activity as directors[63]

This duty forms part of the duty of loyalty. Specific rules apply to situations where a director participates in another company. The law also contains provisions on other conflicts of interest more generally.

As described above,[64] the first category is regulated in section 237 (3) of the Commercial Act. In this provision there is a duty for the nominee for board member to notify the company's body which will appoint him (the general meeting or the supervisory board) regarding his participation in another company as a shareholder with unlimited liability or with more than 25% of the capital or for his participation in the management of other companies or co-operative societies as authorized officer,

[62] Angel Kalaidjiev *The Public Company* (IK Trud I Pravo 2002).
[63] Commercial Act s 237 (3).
[64] Page 13, para 3 of the report.

manager or director (board member). This obligation arises before the appointment of the director and applies until his dismissal.

The second scenario where the director owes this duty is with regard to a potential conflict of interests between the company and the director. The law deals separately with two main types of conflicts of interests within this category:

1. Where director or related party to him is interested in specific matter, which is subject of a board resolution and/or subject of discussions on thee board level; and
2. Where director or related party enters into a contract with the shareholders' company, which is beyond the ordinary business activity of the shareholders' company or significantly deviates from the market standards.

Section 238 (4) of the Commercial Act stipulates:

> *Not later than the beginning of the board meeting a member of the board shall be obliged to inform in writing its chairman that he or a party related to him is interested in an issue to be discussed by the board and he does not participate in passing the resolution.*

The term "related party" (or "related person") is defined in paragraph 1 item 1 of the Supplementary provisions of the Commercial Act.[65] A director disclosing such a conflict of interest must not participate in any board resolution relating to the issue he is interested in, and the director must not participate in any discussions of such matter. Where an interested board member does not comply with the aforementioned obligations, this may render the resolution of the board void.[66]

The second type (ie self-dealing) is governed by the provision of section 240b of the Commerce Act (*"Contracts with the members of boards and related persons"*):

1) The members of boards shall be obliged to inform in writing the board of directors, respectively the management board, when they or persons, related to them, conclude contracts with the company beyond its ordinary activity or substantially depart from the market conditions.
2) The contracts under para 1 shall be concluded on the grounds of a resolution of the board of directors, respectively of the managing board.
3) A transaction concluded in violation of para 2 shall be valid, and the person having concluded it, knowingly or having been able to know that such a decision is missing, shall be liable for the damage caused to the company.

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[65] § 1. (1) "Related persons" within the meaning of this Law shall be:
1. Spouses, relatives on direct line of descent - without any restrictions, relatives on collateral line of descent - up to and including the fourth degree, and in-law lineage - up to and including the third degree;
2. Employers and employees;
3. Persons one of which is involved in the management of the other one's company;
4. Partners;
5. A company and a person who owns more than 5 percent of the company's voting shares and stock;
6. Persons whose activities are under the direct or indirect control of a third party;
7. Persons who exercise joint direct or indirect control over a third party;
8. Persons one of whom is a commercial agent of the other;
9. Persons one of whom has made a donation in favour of the other.
(2) "Related persons" shall be also persons who either directly or indirectly participate in the management, control or capital of another person or persons, which may enable them to agree on terms and conditions which differ from the standard practice.

[66] The possibility for challenging the legality (legitimacy) of the resolutions of the board is recognized with the reasons on item 3 of Judgment TR 1/ 06.12.2002 on commercial case 1/ 2002 GMCD SCC; Alexander Katzarsky (n 43).

In this provision the term "ordinary activity" means any business activity which has so far not been conducted regularly or usually by the company.[67] The prohibition does not impact on the legal validity of the transaction. The director who enters into the transaction on behalf of the shareholders' company and is not acting in good faith (because he knows or by acting with the due care must know that for this transaction a resolution of the board is required and it is not passed), he is liable to the company for the damage suffered by the latter. The director who is in breach of his duty to disclose the conflict of interests is liable for the damage of the shareholders' company caused by the transaction and could be dismissed. This liability requires culpable behaviour on the part of the director.[68]

3.1.3 Duty to manage the shareholders' company[69]

Directors have also the duty to manage the company which stems from the widely held view in academia and court practice that the legal relation between the director and the shareholders' company derives from the mandate. The leading commentators[70] state that the corporate governance activity of the members of the management body could be divided into three categories:

1. Organisation matters: This includes preparation of the annual and the special (extraordinary) general meeting, incorporation of all committees and bodies of the company, appointment and dismissal of employees, business transactions, accountability etc.
2. Management issues: This concerns all activities for planning and enforcement of the company's strategy and course of business, corporate governance issues, management, coordination and control over the company. The board members should attend the board meetings and participate in them, be aware with the statutes of the shareholders' company and its internal acts, be informed of the resolutions of the company's bodies and to comply with them.[71]
3. Control issues: Where mechanisms for internal control are provided in order to supervise the company's activity and its compliance with the strategy of the company.

3.2 To whom are the duties owed?

Regarding the question to whom the duties are owed, the provision of section 237 (2) of the Commercial Act address this issue, stating that the members of the boards are obliged to execute their functions for the benefit[72] of the company and all shareholders. In a judgment of the Supreme Court of Cassation is held that:

The interests of the company as separate legal entity are formed by the General meeting, i.e. the majority, although not always these interests coincide due the fact that very often there isn't coincident with the interests of all shareholders, and, namely for this reason, is implemented the provision of section 237 (2) of the Commercial Act, where the duty of the board members to execute their functions for the interest of all shareholders is added.

[67] Alexander Katzarsky (n 43) With the meaning of objective liability for such liability, where the intention is irrelevant.
[68] Ibid 66.
[69] Angel Kalaidjiev (n 43) 115; Vitali Tadjer and others (n 16) 193.
[70] Vitali Tajer and others (n 16) 193; ibid 13.
[71] Angel Kalaidjiev (n 43) 115.
[72] The original term used in s 237 (2) of the Commercial act is "in the interest of the Company and all shareholders."

It could be concluded, that the shareholder primacy is recognised as the main feature of the concept of the interests of the company.

3.3 The time span of the duties

Between the company and the board's members may originate two types of relationships – a) by virtue of the law and b) by virtue of the management contract (contractual one).

The duties, arising from the relationship *by virtue of the law* are the ones, discussed above. They originate only after the inscription of the board's member in the Companies Registrar and terminate with deletion of the name of the board's member from the registrar. There are three exceptions from this rule:

- Firstly, this is the duty to disclose to the company the facts, prescribed in section 237 (3) of the Commercial Act. The nominee for board member is obliged to notify the company's body that will appoint him (the general meeting or the supervisory board) regarding his participation in other companies as shareholder with unlimited liability or with more than 25% of the capital or for his participation in the management of other companies or co-operative societies as authorized officer[73], manager or board's member. This obligation arises before the appointment of the nominee as a board's member and is applicable until his dismissal. If the relevant circumstances occur after the appointment of the board's member as such, he is obliged to inform immediately in writing the respective organ of the company;
- Secondly, in case of change of the members of the board or the company's representation, the newly chosen members or representatives shall file the documents in the Companies Registrar (s. 15 (6) Commercial Register Act);
- Thirdly, there is one exception where the duty continues its existence even after the formal dismissal of the director and this is the duty for non-disclosure (confidentiality).[74] Pursuant section 237 (5) of the Commercial Act:

The members of the boards shall be obliged not to make public the information having become known to them in their capacity as board members, if this would affect the activity and the development of the company, including after they cease to be members of the board.

The beginning and the end of the contractual obligations is set out into the management contract and could vary.

"[73]"Prokurist" in German.
[74] Alexander Katzarsky (n 43).

4 LIABILITY FOR BREACH OF DUTY

The Commercial Act section 240(2) explicitly provides liability for members of the board of a shareholders' company. They are jointly and severally liable for damage caused to the company due to breach of their duties. Their liability is culpable.[75]

The prerequisites for liability are the same as those of the delict (tort), namely: an act or omission which is wrongful; damage must be caused; there must be a causal connection between the wrongful act/omission and the damage and the act or omission to be done culpable.[76]

The characterization of the liability of board members of shareholders' companies under section 240 (2) Commercial Act is ambiguous and no established constant court practice is in place. There is inconclusive court practice pointing in both directions towards contractual and delictual liability.[77] Some judgements differentiate between the breach of different duties and classify the liability as either contractual or delictual. Others expressly state that irrespective of the specific duty breached, the liability is either contractual or delictual. Nevertheless, no definite answer to the nature of the duties and the liability for their breach has been given by the Bulgarian legal system, neither in statutory law, nor in court practice.

This issue is subject to recent debate both in court practice and academia. Traditionally, the doctrine[78] supports the view that this liability is contractual, while some authors claim that it is neither contractual, nor delictual, but a specific type of civil liability.[79] The latter statement is not popular.

4.1 Duty of care: conditions for liability

As stated above, the following conditions must be proved to establish liability.

4.1.1 Act or omission

This could be an act or omission which is in breach of any duty[80] of the member of the boards, deriving either of specific or from general obligation.

[75] The members of the board are jointly liable for damage, culpably caused to the company, s 240 (2) Commercial Act. The manager and the controller of the limited liability company are pecuniary liable for damage caused to the company, s 145 of the Commercial Act.
[76] Thus Judgment from 10.04.2006 On appeal commercial case № 664/2005 Court of Appeal Veliko Tarnovo, and Judgment from 13.11.2003 on appeal civil case № 223/2002 Court of Appeal Veliko Tarnovo.
[77] In favour of the Contractual nature of the liability: Leave to appeal № 996 /19.12.2011 г. Case № 791/2011 SCC; Leave to appeal№ 47/26.01.2010 Case № 875/ 2009 SCC, Commercial Divison; In favour of the Tort law characterisation: Judgment № 360/04.07.2006 on civil case 197/2005, SCC, First Commercial Division; Judgment № 41/29.04.2009 Case № 669/2008 , First Commercial Division SCC; Leave to appeal № 214/04.04.2011 г. Case № 927/2010 SCC.
[78] Aneta Antonova *Current Amendments in the Commercial Act* Business and Commercial Law Journal issue 2 2011, Nikolay Kolev *Issues on management and representation of ublic company (analysis of the case-law)* Business Law Journal Issue 1 2008 p 25, Vitali Tadjer and others, *Capital Companies* (IK Trud I pravo 2011) etc. Polya Goleva *Tort Law* (IK Feneya, 2011) p 33 supports the view that the liability of the member of the board under s 236 is delicutal liability.
[79] Valchin Daskalov *The liability of the management bodies of capital companies for damage caused to the company – contractual or delictual?* Business Law Journal issue 3 2007 p 37.
[80] For example, duty to manage the public company. Another duty is this provided in s 179 (2) of the Commercial Act for the persons, representing the public company, to provide entering in the shareholders' book of specific circumstances under Para.

4.1.2 Illegality

The general principles of Bulgarian private law apply here. Every behaviour which infringes the requirements of the mandatory rule is illegal. In relation to contractual liability the illegality consists of non-delivery of the result owed by the debtor to the creditor. Thus the illegality consists of infringement of the principle "Pacta sunt servanda", provided in Part 20a (1) of Obligations and Contracts Act.[81]

4.1.3 Acting in a culpable way

As clarified above, an objective standard is used. This is the due diligence owed by the good merchant. This standard is provided in section 237 (2) of the Commercial Act which stipulates "The members of the boards shall be obliged to perform their functions with the due diligence of a good merchant to the interest of the company and all shareholders."[82] It is not possible for director to exculpate due to his insufficient qualities or abilities.

Malice

One who acts with malice (intentionally, willfully):

Realizes that his behaviour is wrongful and is not in compliance with the due diligence of the good merchant (with the meaning clarified in section 3.1 of the report);

Anticipates the possibility this behaviours to cause damage;

Wishes (direct malice) or assume (indirect malice) the causation of damage.[83]

Negligence

A member of the board acts negligently if he or she did not apply the due diligence of the good merchant. The due diligence that is required is that of the professional group to which the board member belongs which is that of the managers of shareholders' companies. The application of the due diligence requires the board members to do an independent evaluation and to choose the most appropriate solution for the company. The due diligence has to be considered with the risk exposure of the company.[84] The court practice [85] explicitly states that:

> *In order to be found ground for liability for damage caused by director acting not in good faith when applying the due diligence, not only the negative or bad economic result for the company for specified period should be considered. It is necessary to be found behavior which is not in good faith – intentionally or negligent, grounded with specific infrigment of the relevant rules for business activity of the company and in the specific national economic situation.*

1. Also, when the director didn't provide any relevant information regarding examination, conducted by the Commission for Protection of Competition , according to Judgment № 10919/27.07.2011 on administrative case № 12557/2010 Г., VII Division, Supreme Administrative Court

[81] Angel *Kalaidjiev Contract Law* (Sibi 2007 4th edition) 392.

[82] It is known that according to section 237 (2) of the Commercial Act that the members of the boards are obliged to execute their functions with the due diligence of the proper and diligent merchant. Ibid 83.

[83] Angel Kalaidjiev (n 45) 485.

[84] Ibid 83.

[85] Judgement №395/ 15.08.2005 on civil case № 725/2004 Second Commercial Division SCC.

Under Bulgarian private law the principle "No liability without fault" applies on the grounds of s 45 (1) and 81 (1) of the Obligations and Contracts Act.[86]

In addition, section 45 (2) of the Obligations and Contracts Act governs the fault under tort liability with a rebuttable presumption.[87] Within the same meaning is the provision of section 79 of this Act which sets as premise for the creditor's pretention for damage only the default and the damage.[88] It is beyond doubt that the fault is presumed under Bulgarian private law. The courts have supported the opposite view:[89]

> *The fault (culpa) of the members of the board of directors for damage caused to the company is not presumed. It has to be proven, as well as the casual link (casual connection) between the specific culpable acts and omissions and the damage caused to the company.*

In another judgment[90] it was held that:

> *Notwithstanding that according to the court the act is committed negligently, it is culpable in the meaning of section 240 (2) of the Commercial Act and the members of the board are jointly liable.*

4.1.4 Damage

Damage to the company must have occurred which might be either suffered loss or opportunity costs. It should be proved by the claimant as well. This damage could consist of decrease of the equity of the company (suffered loss) or neglecting of potential benefits (opportunity costs).[91] The members of the board are liable for all damage which are direct and immediate consequence of their wrongful behaviour.

4.1.5 Loss causation

There has to be a sufficient causal connection between the breach of duty and the loss, according to the theory of adequate causation. This causal connection should be proved to exist between the specific culpable acts and omissions of the director and the damage sustained by the company.[92]

4.1.6 Who bears the burden of proof

According to the provision of section 127 (1) of the Civil Procedure Code for allocation of the burden of proof, the plaintiff, namely, the shareholders' company, has the burden of proof to prove the willfully committed illegal act or omission by the director.[93] Thus all elements described above, except the fault, should be proved by the company ie breach of duty, damage for the company and loss

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[86] Angel *Kalaidjiev Contract Law* (Sibi 2007 4th edition) 412.
[87] See e.g. *Valchin Daskalov*,"Verantwortlichkeit und Haftung der Leitungsgremien der Aktiengesellschaft nach bulgarischem Recht" in: Susanne Kalss*, Vorstandshaftung in 15 europäischen Ländern* (Vienna: Linde 2005) 320.
[88] Angel Kalaidjiev *Contract Law* (Sibi 2007 4th edition) 420.
[89] Judgment № 59/09.02.2007 on commercial case № 531/2006 First Commercial Division SCC.
[90] Judgment from 10.04.2006 on appeal commercial case № 664/2005 Court of Appeal Veliko Tarnovo.
[91] Ognyan Gerdjikov *Commentary on the Commercial Act. Volume 2 (*IK Trud I Pravo) 540.
[92] Ibid 86.
[93] Judgment № 426/16.08.2005 on commercial case № 725/2004 Second Commercial Division SCC.

causation. As described above, the fault is presumed under Bulgarian private law. The defendant should prove that he was acting with the due diligence owed by the proper and diligent manager.

4.2 Duty of loyalty: conditions for liability

As specified above, although the duty of loyalty is not explicitly provided as such in the Commercial Act, it is accepted by both doctrine and court practice that it exists and derives from the legal relation between the director and the company, which originates from the mandate. Consequently, the three specific duties provided in the Commercial Act are to be examined and interpreted as being part of the general duty of loyalty.

To establish liability for a breach of duty of loyalty, the same conditions must be established which are required under section 240(2). Hence, there must be an act or omission which constitutes a breach of the duty, the act or omission must be wrongful, there must be damage to the company, there must be a causal connection between the loss and the breach and the director must be culpable. These elements of liability are identical as those specified above in 4.1. However, although the conditions for liability (damage, loss causation and acting in culpable way) are the same, the type of breach of differs due to the different behaviour covered by them.

The allocation of the burden of proof is the same as described above in 4.1.3. Where additional prerequisites are claimed (e.g. director being interested in the resolution passed by the board; the deviation of the terms of the contract from the standard market conditions etc.) they have to be proved by the plaintiff in addition to the aforementioned elements of the set of facts of the liability.

4.3 Duty to manage: conditions of liability

The conditions for liability are the same as these of the breach of the duty for care where the first element will be act or omission in breach of specific duty. This specific duty should be performed with the due diligence of the proper and diligent manager. The duty of care is established in order to provide the performance of the main duty which is to manage the company.[94] Thus when executing his management functions, the board member should apply the due diligence.

4.4 Exemptions and limitations

4.4.1 Indemnification

The members of the board of directors, of the supervisory board and the managing board (hereafter referred to as “board members”) may be released from liability solely by the General Meeting of the shareholders’ company under section 221, item 10 of the Commercial Act. There is no explicit provision for the shareholders’ companies providing the release from responsibility to be made on the annual general meeting, but this is the current corporate practice.

[94] Ognyan Gerdjikov *Commentary on the Commercial Act. Volum*e 2 (IK Trud i pravo) 533.

There is, though, an explicit regulation regarding public companies, concerning the release from liability of the board members by the annual general meeting, (section 116c, (7) of the Public Offering of Securities Act). The general meeting of the public company can indemnify member of management and control body at a regular annual general meeting if there is an annual financial report (certified by a registered auditor) for the previous year or an intermediate financial report for the period from the beginning of the current financial year until the last day of the month preceding the summoning of the general meeting. The general meeting passes a resolution for indemnification of the members of the boards with ordinary majority. This rule is also mandatory and cannot be amended with the statutes of the public company.

Indemnification done in advance or in violation of these requirements is void. Indemnification which is subsequent but is in violation of these rules is not void, but could be revoked by claim under section 74 of the Commercial Act.[95]

To conclude, the legal regulation about this issue is scarce. So is the court practice. It is a widely established practice the minutes of the annual general meeting that only mention that the members of the respective board are released from liability, without describing any specific misdeed (violation and caused to the company damages) for which the release from responsibility actually takes place. In the legal theory is maintained that release from responsibility can be valid only for a specific misdeed and that the minutes shall mention expressly the damages, their amount and the misdeed itself.[96] Otherwise the company's members may be totally unaware of some misdeeds for which the release from responsibility is asked. No preliminary consent by the general meeting may release the boards' members from liability. If released, the board members are released from liability vis-a-vis the company. The shareholders preserve their right to instigate procedure against the board members.[97]

4.4.2 Exemptions from the duty of care

Exemption from the duty of care cannot be provided in the articles of association/company statutes due to the mandatory character of the rule of 237 (2) of the Commercial Act.[98]

An indemnification might be given to the directors solely by the general meeting of the shareholders' company under section 221, item 10 of the Commercial Act:

> The general meeting shall indemnify the members of the supervisory board and managing board, or of the board of directors as the case may be.

Pursuant s 116c (7) of the Public Offering of Securities Act the general meeting of the public company can indemnify members of management and control body.

4.4.3 Exemptions for duty of loyalty

Significant differences exist in regards to the exemptions of liability for each of the three duties within the duty of loyalty and each will be examined in the following paragraph.

95 A Kalaidjiev *The Public Company* 120.
96 Kr. Stoychev. Commercial companies with registered capital. Management and its legal regulation, 1992, Sofia. Edition of the Bulgarian Academy of Sciences, p. 111.
97 Ibid.
98 O Gerdjikov (n 93) 546.

Duty to restrain from exercising competing activity unless otherwise stipulated

The provision of section 237 (4) is optional and could be eliminated or expanded by clause in the company's statute.[99] It could be entirely abolished by the competent body of the company which will pass resolution for appointment of the board member (the general meeting for one-tier board structure and the general meeting and the supervisory board for two-tier) to exempt all or some of the board members from this duty. This exemption could be in full or partial, for specific transactions, or for participation in specific companies, other than the shareholders' company, or for certain period. As mentioned above, this duty is owed until dismissal of the director.

Duty for non – disclosure (confidentiality)

The provision of section 237 (5) of the Commercial Act contains mandatory rule in favour of the company. Hence, only the company has the right to change it.

Duty to disclose to the company facts which might be relevant to their activity as directors:

The duty to disclose relevant information cannot be exempted by the statutes of the company. The Supreme Court of Cassation[100] held that

> *The aim of this rule is to provide guarantee for the interests of the company when passing resolution for appointment of director. This guarantee is provided in section 237 (3) of the Commercial Act which establishes statutory duty for nominees to inform the company body, competent to appoint them, for specified circumstances. This notification is due by every nominee and there is no special form in which to be given. The competent for the appointment company body could request additional information regarding the nominee and its commitments.*

The disclosure obligation applies, in particular:

1. Where the director or a related party has an interest in relation to a matter to be resolved by the board (section 238 (4) of the Commercial Act);
2. Where the director or a related party enters into contract with the shareholders' company, which is beyond the ordinary business activity of the shareholders' company or significantly deviates from the market standards (section 240 b of the Commercial Act).

These two provisions are mandatory and cannot be derogated by clause at the company statutes. The provision of section 240b is special (specific) rule for conflict of interests as regards to the general rule in section 238 (2).[101]

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[99] Alexander Katzarsky *The Amendments in the Company Law, enacted on July 1 2003* Business Law Journal issue 4 2003.

[100] Judgment № 66/19.05.2010 on civil case № 832/2009 First Civil Division SCC. The court also held**: "**The meaning of the accuracy, genuineness and exhaustiveness of the information provided by the nominee is relevant to the possibility of his subsequent dismissal. Thus, if the company suffered damage which is direct consequence of default of this duty for notification with respect to other acts of non-loyalty of the appointed member of the board, for these acts he could be held liable under the general provision."

[101] Kamelia Kasabova *Protection of the Shareholders in Public Company and Listed Public Company* (IK Trud I Pravo 2010) 109.

Indemnification

As described above, an indemnification might be given to the directors solely by the general meeting of the shareholders' company under section 221, item 10 of the Commercial Act.

4.4.4 Exemptions for the duty to manage

This duty cannot be waived or derogated by the statues of the company. The general rule for indemnification by the General meeting applies.

4.5 Consequences of liability

4.5.1 Duty of care

Pursuant section 240 (2) of the Commercial Act the members of the board are jointly liable for damage, culpably caused to the company. Pursuant s 240 (3) any director may be indemnified if it is inferred that he has no fault for the damage.

The board members are liable for direct and immediate damage, which might be assumed upon formation of his duties. Nevertheless, if he wasn't acting in good faith, acted with gross negligence, he will be then liable for all direct and immediate damage in the same way as the delinquent is liable for tort (delict).[102]

All the transactions entered into on behalf of the company are valid regardless of the type duty which the director owes and has breached.

4.5.2 Duty of loyalty

Pursuant section 240 (2) of the Commercial Act the members of the board are jointly liable for damage, culpably caused to the company.

The board members are liable for direct and immediate damage, which might be assumed upon formation of his duties. Nevertheless, if the board member wasn't acting in good faith, acted with gross negligence, he will be then liable for all direct and immediate damage in the same way as the delinquent is liable for tort (delict[).103]

In addition to the liability for damage, the directors might be dismissed. However, for breach of duty to disclose relevant information before appointment, the directors may only dismissed but not be held liable for damage.[104]

[102] Ognyan Gerdjikov (n 93).
[103] Ognyan Gerdjikov (n 92).
[104] Alexander Katzarsky *The Amendments in the Company Law, enacted on July 1 2003* Business Law Journal issue 4 2003.

4.6 Guarantee

Section 240 Commercial Law stipulates:

> (1) The directors shall deposit a guarantee for their management of the affairs of the company in an amount determined by the general meeting, but not less than their three month gross remuneration. The guarantee may be in the form of shares or bonds deposited with the company.

In order effective and duly deposition of the guarantee to be ensured by the directors of listed companies,[105] special requirements are provided with section 116c Public Offering of Securities Act.[106] It also provides when the guarantee will be released.

[105] Angel Kalaidjiev*, The Public Company* (IK Trud I Pravo 2002) 120.
[106] Public Offering of Securities Act s 116c.
…(2) The persons of para 1 shall be obliged in 7 days term after being elected to pay guarantees for their management.
(3) The guarantee shall be paid in leva. The extent of the guarantee shall be determined by the general meeting of the stock holders and it cannot be less than the 3 months gross remuneration of the persons of para 1.
(4) The guarantee shall be blocked in favour of the company in a bank on the territory of the country. The interests from the guarantees, blocked in a bank, shall be free and can be drawn upon request by the payer of the guarantee.
(5) In case of not payment of the guarantee within the defined term the respective body shall not receive remuneration as member of the respective body till the payment of the full extent of the guarantee.

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 The meaning of 'vicinity of insolvency'

The causes for insolvency proceedings are provided in the Commercial Act s 607a and there are two grounds: balance - sheet insolvency (referred as over-indebtedness) and cash flow insolvency. These two grounds for insolvency have legal definitions in the Commercial Act.[107]

The Commercial Act Section 222 (3) in conjunction with s 223 (1) provides duty for the board members to convene general meeting which has to take place not later than three months after the losses have been ascertained. It stipulates:

> If the losses exceed ½ of the inscribed capital of the company general meeting shall be held not later than three months from ascertaining the losses.

The duty to file for insolvency is provided with the provision of the Commercial Act section 626 which stipulates:

1) In case of insolvency or over-indebtedness any debtor is obliged to file a petition for opening of insolvency proceedings within 30 days.
2) The petition pursuant to paragraph 1 is filed by the debtor, his heir, and the management body or the representative, respectively liquidator of a company or unlimited partner.

The liability for breach of this duty is provided in the Commercial Act s 627:

> For breach of this duty for filing for insolvency by the persons according to s 626, subsection 2, they will be jointly and severally liable vis-à-vis the creditors of the company for damage caused by the delay.[108]

In addition, criminal liability is provided for breach of the latter duty.[109]

[107] Cash-flow insolvency (inability for payments) is governed by Commercial Act s 608 and the balance-sheet insolvency (over – indebtedness) is determined in s 742.
[108] See *Valchin Daskalov*,"Verantwortlichkeit und Haftung der Leitungsgremien der Aktiengesellschaft nach bulgarischem Recht" in: Susanne Kalss*, Vorstandshaftung in 15 europäischen Ländern* (Vienna: Linde 2005) 347 for a discussion of how the damage is calculated.
[109] See item 6 below.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue

6.1.1 The company as plaintiff

The director's duties are owed to the company and it has standing to sue for damage, as described above.

6.1.2 The shareholders as plaintiffs

6.1.2.1 In their own name

Direct claims from shareholders vis-à-vis the directors for damage caused to them should be based on tort law and there are no specific provisions in the company law which regulate additional means of protection. The shareholders do not have standing to sue the directors for the diminishment of the market value of their shares just on the grounds that the directors have managed the company inappropriately (and thus the company has acquired bad image), because in this case proximate causation lacks. Only if there is an agreement between the shareholders and the directors, the latter to be responsible for the diminishment of the market value of the shares, such responsibility can be sought; but in this case the responsibility will be a contractual, not tort one.

6.1.2.2 In the name of the company ('derivative action')

Derivative action is provided for shareholders to sue the directors for damage caused to the company. The provision of Commercial Act Section 240a governs the derivative suit under Bulgarian Company law. It is titled "Liability upon request of shareholders" and stipulates:

Shareholders who own at least 10 per cent of the capital of the company may bring an action for holding liable the members of the board of directors, respectively of the Supervisory board and Managing board, for damage caused to the company.

Before the amendments of the Commercial Act in 2003 this right was provided for shareholders with 5 per cent of the capital but the threshold was increased to 10 per cent.[110] The type of shares owned by the shareholders is not relevant. The period of share ownership is also irrelevant.[111] It is minority right, not right of the individual shareholder, unless the latter owns at least ten per cent of the capital of the shareholders' company.

[110] The 5% threshold still applies to public companies with dispersed shareholding; *Valchin Daskalov*,"Verantwortlichkeit und Haftung der Leitungsgremien der Aktiengesellschaft nach bulgarischem Recht" in: Susanne Kalss*, Vorstandshaftung in 15 europäischen Ländern* (Vienna: Linde 2005) 323.

[111] A Kalaidjiev, P Goleva and others *Commentary on the Amendments of the Commercial Act* (IK Trud I Pravo 2003) 105 eg. The right under Commercial Act s 223 to request convention of the General Meeting have shareholders who own at least 5 per cent of the capital from at least three months.

All board members can be held liable. However, the shareholders may also bring the action vis-à-vis some of the members, not vis-à-vis all of them. It should be noted that the shareholders have the right to bring the claim and the disputed material right, regardless of the fact that the disputed material right belongs to the company, not to the shareholders.[112] When bringing the claim, the shareholders should request judgment to be awarded for the benefit of the company.

Defendants under the derivative suit are the members of the boards who have caused damage to the company with their acts or omissions. It is suggested by academics[113] that the authorized officer of the company *(prokurist)* should also be liable.

The cause of action is damage caused to the company by the directors. Another prerequisite is loss causation between damage and the acts or omissions. Namely the acts or omission should be in breach of some of the director's duties. The fault is compulsory prerequisite in order for a board member to be found liable and it is presumed.[114]

Court approval is not necessary in order the claim to be processed as it is required in other jurisdictions.

The derivative suit for shareholders of a public company is governed by Public Offering of Securities Act s 118 (2) item 1[115] and establishes different requirements regarding the minimum percentage of the shares owned in order the shareholders to be able to bring the claim (persons holding together or separately at least 5 percent of the capital of a public company, etc.)

6.2 Criminal and administrative sanctions

Different administrative sanctions are provided for directors for non-compliance with specific rules.[116] Generally, these sanctions are granted under the rules of the administrative law in the Act on administrative infringements and penalties, Administrative Procedure Code, etc.

Moreover, criminal liability is provided in the Criminal Code, Chapter VI "Crime Against the Economy", Section 1 "Crimes against the creditors".

[112] Kalaidjiev*, The Public Company* (IK Trud I Pravo 2002) 63.
[113] Kamelia Kasabova *Protection of the Shareholders in Public Company and Listed Public Company* (IK Trud I Pravo 2010) 143.
[114] Kamelia Kasabova (n 114).
[115] Art. 118. (1) Persons holding together or separately at least 5 percent of the capital of a public company, in case of inactivity of its managing bodies, which threatens the interests of the company, can lay the claims of the company against third persons in court. The company shall also be subpoenaed as a party to the case.
(2) The persons under para 1 can:
1. lay claim before the county court at the headquarters of the company for indemnification of damages, caused to the company by actions or lack of action of the members of the managing and the control bodies and of the procurators of the company;
2. require from the general meeting or from the county court the appointment of controllers, who are to check the whole accounting documentation of the company and prepare report about their findings;
3. require from the county court summoning of the general meeting or authorisation of their representative to summon general meeting with agenda, determined by them;
4. (new – SG 23/09, in force from 27.03.2009) require inscription of issues and propose decisions on already included issues in the agenda of the general meeting pursuant to the provisions of Art. 223a of the Commercial Law.
(3) (new – SG 61/02) The court shall decide immediately about the requirements of para 2, items 2 and 3.
[116] Act for Protection of Competition s 102; Criminal Code s 227b.

Pursuant to s227b(1) and (2) persons who manage and represent the company if, within 15 days from suspending of payments, have not requested the court to start insolvency proceedings shall be punished by imprisonment of up to three years or by a fine. Subsection 4 provides such liability also for persons who, being obliged to inform the Bulgarian National Bank about the insolvency of a bank according to the Credit Institutions Act, have not done so. Another example for criminal liability is this which may arise for the directors for intentional[117] or negligent[118] bankruptcy.

[117] The Criminal Code, section 227c. (1) A merchant who, after the institution of bankruptcy proceedings:
1. conceals, destroys, damages or alienates ex gratia money, possessions, securities or other valuables which can serve as indemnification of his creditors;
2. alienates money, possessions, securities or other valuables which can serve as indemnification of his creditors, when the given substantially exceeds the received, and it was done in contradiction to the normal practising of the economic activity;
3. absolves or conceals a taking;
4. recognises or undertakes in any way whatsoever, or remedy non-existent liability;
5. takes a loan knowing that he cannot return it;
6. cedes as a credit possessed commodities, money, possessions, securities or other valuables in a way contradicting the normal practising of the economic activity;
7. illegally remedies only one or several creditors or secures them to the detriment of the rest of the creditors;
8. destroys, conceals or forges his trade books or documents or keeps them in violation of the law in a way embarrassing the establishment of the assets and liabilities of his enterprise or trade,
if the above acts have caused substantial damages, shall be punished for deliberate bankruptcy by imprisonment of up to three years.(2) When an ac under para 1 causes damages of particularly large size, representing a particularly serious case, the punishment shall be imprisonment of three to fifteen years. The court shall also rule revoking of rights according to art. 37, para 1, item 6 and 7. S 227d. The punishments under art. 227c shall also be awarded to the persons who manage and represent the trade company or cooperation if they commit or admit the commitment of the acts according to the same Art., whereas in the cases of para 1 the court can also rule a fine of up to 500 levs, and under para 2 - confiscation of a part or of the whole property of the culprit.

[118] The Criminal Code s 227e
(1) A merchant who:
1. has not conducted his business activity with due diligence or has taken part in obviously risky transactions which do not belong in the circle of his usual activity;
2. has made personal, family or other expenditures, obviously uncharacteristic and not related to the activity and not complied with his property status;
3. has failed to work out or has worked out an incorrect annual accountancy report and balance, being obliged to do that;
for which reason he has been declared bankrupt and this has caused damages to the creditors, shall be fined for negligent bankruptcy by imprisonment of up to two years, whereas the court can also rule revoking of rights according to art. 37, para 1, item 6 and 7.
(2) The punishments under para 1 shall also be awarded to an entrepreneur who is declared bankrupt without having fulfilled his obligations under a preceding recovery plan.
(3) The punishments under para 1 shall also be awarded to persons who manage and represent the trade company or cooperation if they commit or admit the commitment of the acts stipulated by the same para.
(4) The persons under para 1 shall not be punished if, before the ruling of the verdict by the first instance, they indemnify their creditors. This provision shall not be applied a second time.

7 CONFLICT OF LAWS

7.1 Classification under Bulgaria's private international law

7.1.1 Tort law

Concerning the non-contractual liability of the directors toward third parties, there are no specific rules in the EU or the Bulgarian national law. The relevant law is determined by the Regulation (EC) No 864/2007 as the matters which fall outside its scope are reserved for the relevant international or national law.

7.1.2 Special duties in the vicinity of insolvency

Concerning the insolvency duties, Council Regulation (EC) No 1346/2000 is applicable to cases where the debtor's main interests are situated in a Member State. If the matter falls outside the application of the Insolvency Regulation, the national law should be applied. The Bulgarian national law determining the law applicable to insolvency proceedings is contained in Commercial Act s-s 757 – 760.

Firstly, concerning the Insolvency Regulation, its scope is defined in art. 4 (1) and (2). The directors' duties are not included expressly in its scope of application. Therefore, the question remains whether the classification of those duties lead to the application of any of the subsection of art. 4(2) of the Insolvency Regulation. As pointed out above, the statutory provisions and the case-law are inconclusive concerning the legal nature of the directors' duties and thus concerning the liability for their breach. Nor is there sufficient court practice involving the application of the Insolvency regulation to the winding up of Bulgarian companies. Therefore, it is not possible to state conclusively that directors' liability falls in or outside the scope of the Council Regulation (EC) No 1346/2000.

Secondly, the provisions of Commercial Act s-s 757 – 760 do not expressly regulate the question of the directors' liability. Therefore, the relevant general principles and provisions of the international private law shall be applied as outlined above.

7.2 Application of the relevant private international law rule

The applicable law to the duties owed by the director to the company falls out of the scope of Rome I (art. 1(2)(f) and (g). The question of applicability of Regulation (EC) No 864/2007, however, is more complicated. Only matters concerning the personal liability for the company's obligations of the officers are excluded from the scope of application of the Regulation (Art. 1 (2)(d)). As a result, matters concerning the personal liability of the directors towards the company itself or personal liability of the officers vis-avis third parties, different from those under Art. 1 (2)(d)Regulation No 864/2007, do not clearly form part of the scope of the regulation. As stated in Recital 11 of the Regulation a non-contractual obligation is an "autonomous concept". Nevertheless, no ECJ case-law is available in order to clarify the matter concerning the applicability of Regulation (EC) No 864/2007 to various aspects of the director liability. If Rome II is to be applied, under art. 4 the law of the seat of the company shall be the relevant applicable law.

However, if it is considered that some or all of the duties of the directors to the company fall out of the scope of Rome II, the characterization shall be carried out on the basis of the national law of the court seized. The Bulgarian court will apply its own national law in that process. The characterization of the directors' duties in the Bulgarian legal system is ambiguous and no established constant court practice is in place. Unfortunately, there is inconclusive court practice pointing in both directions towards contractual and tort liability.[119] Some judgements differentiate between the different breach duties and classify them as either contractual or tortious liability, others expressly state that irrespective of the breach duty the liability is either contractual or tortious. Nevertheless, no definite answer to the nature of the duties and the liability for their breach has been given by the Bulgarian legal system, neither in statutory law, nor in court practice. Traditionally, the doctrine[120] supports the view that this liability is contractual.

After the court has finalised the characterization process under the national law, it will proceed in applying its own national rules of conflicts of law. Most of the national conflicts of law rules of Bulgaria are contained in the Code of International private law (CIPL). Despite the characterization of the liability, the relevant conflict of law provisions does not differentiate between contractual or tort law. Art. 58 of CIPL determines the scope of the matter as in point 4 of art. 58 is included the composition, capacity and functioning of the corporate bodies and in point 8 the consequences of breach of the law and the articles of association. As a body of the corporation (the director or the director of branch), the director is bound by the articles of association and the statutory law. In case of a company branch director, the applicable law is determined by the place of registration of the branch.[121] In case of company director, the specific conflict of law rule states that if that the place of real (central) administration is different from the seat of the company, the applicable law shall be the law of the state of the central administration.[122] If the company has registration in several states, than the relevant applicable law is the place of the seat of the company[123] The general conflict of law rule applicable in all other cases is the law of the place of registration (incorporation).[124]

To conclude, the Bulgarian law has adopted the real seat theory, which applies in all cases except in the case of company branch. As a result, the outcome of the application of the conflict of law rules applicable to directors' duties owed to company is similar to the one achieved in the court practice in Konamaneni v Rolls-Royce Industrial power [125] (concerning the equitable duties) as well as the Companies Act 2006 (concerning the statutory duties).

[119] In favour of the Contractual nature of the liability: Leave to appeal № 996 /19.12.2011 г. Case № 791/2011 SCC; Leave to appeal№ 47/26.01.2010 Case № 875/ 2009 SCC, Commercial Division; In favour of the Tort law characterisation: Judgment № 41/29.04.2009 Case № 669/2008 , First Commercial Division SCC; Leave to appeal № 214/04.04.2011 г. Case № 927/2010 SCC.

[120] Aneta Antonova *Current Amendments in the Commercial Act* Business and Commercial Law Journal issue 2 2011. Thus Nikolay Kolev (n). Polya Goleva *Tort Law* (IK Feneya, 2011) p 33 supports the view that the liability of the member of the board under s 236 is tort liability.

[121] CIPL s 56, subs 4.

[122] CIPL s 56 subs 3.

[123] CIPL s 56 subs 2.

[124] CIPL s 56 subs 1.

[125] Konamaneni v RollsRoyceIndustrialPower (India) Ltd, Chancery Division20 December 2001. CaseAnalysisWhereReported[2002] 1 W.L.R. 1269.

Furthermore, it should be pointed out that if Rome II Regulation is applied to the directors' liability, the outcome reached would be virtually the same.

In conclusion, there is a good cohesion between substantive and international private law concerning directors' duties in Bulgarian companies. However, the only unresolved matter remains the application of Regulation (EC) No 864/2007 (Rome II) concerning the legal nature of the liability for breach of the director's duties. Is it to be classified as non-contractual, contractual or a matter for national law, it remains to be determined by the court practice.

Directors' Duties and Liability in Croatia

Initial author: Antun Bilić

CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in Croatia

In Croatia company law is codified in a single statute, Companies Act 1993 (hereinafter: Companies Act).[1] Before 1991 Croatia was a part of the Socialist Federal Republic of Yugoslavia and, accordingly, it had no company law comparable to any contemporary capitalistic system. Instead of companies, in Yugoslavia there existed Organizations of Associated Labour (so-called OUR), which were based not on private ownership, but on investment of labour. The first partial adoption of the capitalistic company law was made by Undertakings Act 1989 and full transition was achieved by the enacting of Companies Act in 1993. With the enactment of the Companies Act Croatia accepted a system of company law very similar to German law, which was also in accordance with its own pre-socialist legal tradition. Companies Act was substantially amended in 2003, 2007 and 2009 in order to comply with the requirements of European directives. It contains complete regulation of company directors, their duties and liability.

In the area of company law an important piece of legislation is also *Act on the Takeover of Public Limited Companies 2007*[2] which regulates conditions for takeover of public limited companies and the takeover procedure. In 2008 the *Capital Market Act 2008*[3] was enacted to regulate, among others, conditions for offering securities and their trading on the regulated market. Although those statutes do not contain provisions on directors' duties and liability many of their requirements are in practice executed by company directors.

Apart from the provisions of the Company Law, the provisions of *Bankruptcy Act 1996* (hereinafter: *Bankruptcy Act*)[4] are especially important for the regulation of directors' duties and liability since they provide for the liability of directors in the vicinity of bankruptcy, in cases of cash flow or balance sheet insolvency. Directors can also be subsidiarily liable under general law of obligations if preconditions set by that law are met. The provisions of *Obligations Act 2005* (hereinafter: *Obligations Act*)[5] are applicable, particularly those on the standard of care in performing obligations and on the compensation of damages.[6]

1.2 Corporate landscape in Croatia

Companies Act envisages the following types of commercial companies: general partnership, limited partnership and economic interest grouping as partnerships; public limited company and limited liability company as corporations. The public limited company (hereinafter: PLC) is the only company whose shares are designated to be held by a wide scope of shareholders. PLC shares can be traded either in a regulated market (administered by a stock exchange) or outside of it. Although some particular provisions apply to PLCs whose shares are traded in a regulated market, Croatian law does not regulate listed and non-listed companies in a fundamentally different way. Directors' duties and

[1] Zakon o trgovačkim društvima, Official Gazette No. 111/93, 34/99, 121/99, 52/00, 118/03, 107/07, 146/08, 137/09.
[2] Zakon o preuzimanju dioničkih društava, Official gazette No. 109/07, 36/09.
[3] Zakon o tržištu kapitala, Official Gazette No. 88/08, 146/08, 74/09.
[4] Stečajni zakon, Offficial Gazette No. 44/96, 29/99, 129/00, 123/03, 82/06, 116/10.
[5] Zakon o obveznim odnosima, Official Gazette No. 35/05, 41/08.
[6] Obligations Act 2005, 10, 1045.

liability are generally the same for all PLCs. The only difference is that PLCs whose shares are traded in a regulated market are entrusted with more tasks and, accordingly, their directors have some additional duties.

One of the differences between the listed and non-listed PLCs is in their obligation to report if they apply the code of corporate governance. The code of corporate governance is soft law, not binding on PLCs, which aims to promote disclosure to the public of the relationship between the various bodies of the PLC. The Companies Act imposes an obligation on PLCs whose shares are traded in a regulated market to make a statement whether they have complied with any code of corporate governance and if not why.[7] In 2007 the Code of Corporate Governance was issued by the Zagreb Stock Exchange and Croatian Financial Services Supervisory Agency

PLCs are not subject to a special set of rules if their shares are predominantly held by a state or a public body. It is considered that when a state acts in a role of a private person, its actions are governed by the private and not the public law. State-controlled companies are not under a different regime concerning directors' duties and liability.

The limited liability company is a private company which in many aspects resembles the PLC. The duties of limited liability company directors are similar to those of PLC and their liability is regulated by reference to the liability of PLC's directors.[8] However, the subject of this report will be only the duties and liability of PLC's directors.

1.3 The board of a Croatian company

Traditionally, Croatia has a two-tier board structure, modelled on the German company law. Thus, the management of the PLC's business is entrusted to the company's management board and the supervision to the supervisory board[9]. Shareholders elect members of the supervisory board in the general meeting and the supervisory board appoints members of the management board. The management board is obliged to report to those bodies and it cannot refuse to give information. However, the management board manages business independently and its members cannot be removed by the supervisory board unless there is an important reason.[10] The general meeting cannot influence decisions of the management board nor can it give mandatory instructions. There is no hierarchical relationship between PLC bodies. Moreover, the management and supervisory board are separated not only by their function, but also personally, because same persons cannot be members of both boards.

With the amendments of the Companies Act from 2007 the one-tier structure was adopted by Croatian law as an alternative to the existing two-tier structure. It consists of only one body, the board of directors, alongside the general meeting. The board of directors both manages the PLC and supervises its activities. Members of the board of directors are functionally divided between those who primarily manage the business (executive directors) and those who supervise it (non-executive directors). Aside from executive directors, the PLC's business is also managed by executive officers

[7] Companies Act, 272.p. This is primarily an obligation of a supervisory board, i.e. board of directors.
[8] Companies Act, 430, 439.
[9] The management board is regulated in Companies Act, Articles 239-253 and the supervisory board in Articles 254-272.
[10] Companies Act 244 (2).

who are appointed by the board of directors, although they are not its members.[11] Unlike in the two-tier system, executive directors and officers cannot conduct the business independently and they have to follow the board's instructions. The impartiality of the supervisory function is ensured by prescribing that the majority of the board's members and its president have to be non-executive directors.

In the articles of association PLC founders choose between the two options provided by *Companies Act*. They cannot compromise and combine features of both structures. Since the one-tier structure is relatively new in the Croatian law and less familiar, there are not many PLCs which have adopted it. It is not likely that it will ever be as frequently represented as the traditional two-tier structure[12].

In the Companies Act the due standard of care and liability of PLC's directors is prescribed in regard to the members (directors) of the management board.[13] The same provisions are *mutatis mutandis* applied to the liability of members of the supervisory board, board of directors and executive officers. This means that the same standard of care is required of all members of the PLC executive and supervisory bodies, only their tasks, to which that standard applies, differ depending on their competences.

1.4 Main features of directors' duties and liability regulation

As a preliminary matter a distinction has to be made between directors' duties and liability. The notion of directors' duties is closely connected to competences of PLC's boards. In order to perform its function within a PLC, a board is entrusted with certain powers, authorities, and tasks. However, those competences are designated not only as the board's rights, but also as its duties. For example, the management board is both authorised and obliged to manage the business and to represent the PLC; the supervisory board is required to supervise the management and to convene the general meeting; the board of directors is required to manage the PLC and to appoint executive officers.[14] Its directors eventually carry out all of the board's tasks, whether by acting together or individually. Through their membership in a board, the powers and duties of the board become also indirectly the powers and the duties of directors. Therefore, directors' duties cannot be separated from the board's activities. Companies Act and other statutes regulate in detail tasks which have to be performed by the PLC's bodies. However, the duties of the directors are wider than the competences of boards whose members they are. They also include the due care with which directors have to perform their activities and some other duties such as loyalty to the company and to keep its business secrets.

While duties are "what has to be done", liabilities are the consequences which occur when "something is not done" or it is "not done in an adequate way". It could be said that liabilities are sanctions which ensure that everything is performed in accordance with the law. Those two notions are closely related and both will be the subject of this report.

The legislative approach of Croatian law can be explained in accordance with such distinction. Powers of the PLC's bodies are connected with their function and, consequently, provided throughout the

[11] The board of directors is regulated in Companies Act 272a-272o and the executive directors and officers in Companies Act 272l-272o.
[12] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 651.
[13] Most important articles are 252, 251, 273, 273(a).
[14] Companies Act, 240, 241, 263 272.h, 272.l.

Companies Act and other statutes which regulate the company law. Main competences are envisaged in Companies Act in a section which deals with PLC's boards; the management board, supervisory board or, in a one-tier structure, the board of directors. They are addressed primarily to those boards and not directors individually, but directors will be liable if they fail in their conduct. The board's competences are defined by the mandatory rules in the statute and neither the articles of association nor the courts have much leeway to derogate from those provisions.

Although the competences are diverse, the due care with which they have to be performed is the same. This is done by providing for a standard of care "of a prudent businessman" and a business judgment rule.[15] This approach has its roots in the general law on obligations where care of a prudent businessman is one of the standards in performing obligations and exercising rights.[16] The advantage of creating a universal standard is that it is equally applicable to all situations and directors' competences. Moreover, such standard is not limited to PLC and it applies also to the due care of limited liability company directors.

Having a general standard means that decisions of courts play an important part in determining what the standard means in specific situations. However, the standard of care of a prudent businessman is rather flexible and it is impossible to frame it in any exclusive number of examples, whether by statute, courts practice or jurisprudence. It always has to be assessed through an objective professional viewpoint applied to each situation in question.

Liability is intertwined with the due care since directors will be liable if they infringe that standard. Apart from that, the Companies Act specifies several additional directors' liability, such as liability for the competition with a PLC, liability for breaching the obligation of keeping the PLC's trade secrets and a number of enumerated activities for which directors are particularly liable.[17] Also, the statute emphasises that directors are liable if they do not exercise due care especially in certain situations, e. g. during the incorporation of a PLC, merging with another company.[18]

The standard of due care and liabilities are always addressed to directors directly. This is due to the fact that the standard of care of a prudent businessman is modelled on the conduct of a natural person and not a body. Also, boards have no legal personality and only the PLC itself or its directors can be held liable.

[15] Companies Act 252, which will be in detailed explained below.
[16] Obligations Act 2005, 10.
[17] Companies Act, 248, 251, 252 (1), 252 (2).
[18] Companies Act 193, 526.

2 The concept of 'company director' in Croatia

2.1 *De iure* directors

A *De iure* director is a director who is appointed as such in accordance with the provisions of the Companies Act.

2.1.1 The management board

The Companies Act provides that its member can be any natural person with full capacity to act. Additional requirements can be provided by the articles of association. However, it cannot be:

- A person who has been convicted of specific economic crimes (preferential treatment of creditors, abuse of the bankruptcy procedure, infringement of the obligation to maintain the business records, disclosure or procurement of business secrets, embezzlement, infringement of third parties' rights) for a time period of five years after the finality of the judgment, not including the time spent serving the sentence;
- A person against whom a safety measure was pronounced forbidding him entirely or partially to engage in business involving the objects of the company, during the time such prohibition remains in force; or
- A person who is a member of the supervisory board of PLC.[19]

The supervisory board appoints members of the management board and its president for a maximum period of five years.[20] The appointment is considered as accomplished when the appointed member accepts it. The management board has an obligation to register any alteration in its composition in the court register as soon as possible.[21] If a member of the management board has not been appointed, in case of emergency, at a request of a person who has interest, the court will appoint the missing member.[22]

2.1.2 The supervisory board

Its member can also be any natural person with full capacity to act, except if there are additional requirements in the articles of association. However it cannot be:

- A person who has been convicted of specific economic crimes (preferential treatment of creditors, abuse of the bankruptcy procedure, infringement of the obligation to maintain the business records, disclosure or procurement of business secrets, embezzlement, infringement of third parties' rights) for a time period of five years after the finality of the judgment, not including the time spent serving the sentence;

[19] Companies Act, 255.
[20] Companies Act, 244.
[21] Companies Act, 245.a.
[22] Companies Act, 245.

- A person against whom a safety measure was pronounced forbidding him entirely or partially to engage in business involving the objects of the company, during the time such prohibition remains in force;
- A person who is already a member of ten supervisory boards or boards of directors;
- A "procurator"[23] of a PLC;
- A member of the management board;
- A member of the management board or Executive Director of a subsidiary company;
- A member of the management board or Executive Director of another PLC or Limited Liability Company in whose supervisory board or board of directors there is one of the members of PLC's management board;[24] or
- A public officer.[25]

Members of the supervisory board are elected by the general meeting.[26] The articles of association can provide that up to one 1/3 of supervisory board's members can be appointed by designated shareholders. In addition, the Labour Act 2009 provides that in every PLC one member of a supervisory board has to be appointed by the employees.[27] If the supervisory board lacks its members in such an amount that it is no longer capable of making decisions, the missing members will be appointed by the court, upon the request of the management board, any member of the supervisory board or shareholders.[28] Members of the supervisory board are elected or appointed for a time period of a maximum of four years. Their mandate begins from the date designated in the decision on the election, i.e. appointment, but not earlier than the member accepts it.[29]

2.1.3 The board of directors

In regard to its members *mutatis mutandis* apply the same rules as for the members of the supervisory board.[30] In regard to the court appointment, a difference is that the court will appoint even those members who are not necessary for making decisions if they are missing for more than three months, and even earlier if the matter is urgent. The board of directors consists of both executive and non-executive directors. Executive directors are, together with executive officers, appointed by the board of directors. The president of the board of directors and the majority of its members have to be non-executive directors.[31] Members of the board of directors and executive officers can be appointed for a maximum of six years.[32]

2.2 *De facto* and shadow directors

2.2.1 De facto directors

Croatian law does not regulate the position of a *de facto* director. It is not provided in statutes nor has

[23] A special kind of representative with a very wide scope of authorities. Regulated in Companies Act, 44-54.
[24] Companies Act, 255.
[25] Act on the Preventing of the Conflict of Interests in Exercise of the Public Office, Official Gazette 26/2011, 12/2012.
[26] Companies Act, 256 (1).
[27] Zakon o radu, Official Gazette No. 149/09, 61/11. Employees right to appoint a member of a supervisory board is provided in article 163.
[28] Companies Act, 257.
[29] Companies Act, 258.
[30] Companies Act, 272.b (2).
[31] Companies Act, 272.i (1), 272.l (1).
[32] Companies Act, 272.c (2), 272.l (1).

it been decided by the courts. Therefore, it is not certain what consequences a *de facto* would face for performing a director's activities. There are two possibilities: that liability of *de facto* director is decided in accordance with the company law or, if the status of *de facto* director is not recognised, that the liability is established under the general law of obligations.

In jurisprudence, based on the reasoning of the German law, it has been suggested that the same standards should be applied to *de facto* and *de iure* directors. *De facto* directors would be those persons whose appointment was not valid due to some defect, or those who have acted as directors both in regard to the PLC and the third persons.[33]

2.2.2 Shadow directors

A shadow director is a person who, although does not perform director's competences, can effectively influence decisions of the PLC's directors. Usually, but not necessarily, this is achieved by holding a majority of shares and/or the voting rights.

Although Croatian law does not address the liability of shadow directors in general, it does provide for the liability of persons who deliberately influence members of the management board, supervisory board, board of directors, executive officers or some other representative to perform an action which causes damage to the PLC or its shareholders.[34] Those persons are liable not only to the PLC, but also directly to shareholders if any damage occurred to them independently from the damage caused to the PLC and its creditors if they cannot satisfy their claim from PLC. Courts have established that damaging influence can be effectuated also by voting in the general meeting.[35] Members of the management board, supervisory board, board of directors and executive officers who infringe their duties are liable jointly and severally with such "shadow directors". Additionally, jointly and severally liable are persons who profited from the damage to the PLC if they participated in it deliberately.[36]

It is visible that the main difference between "*de iure*" and "shadow" directors is that the person who influences directors to cause damage is liable only if it does so deliberately. This was confirmed by the case law.[37] For *de iure* directors, negligence is already sufficient to establish liability.

Decisive influence of one shareholder can be prevented by limiting in the articles of association the maximum number or the maximum percentage of votes which a shareholder can have, irrespective of the amount of shares it holds.[38] Such limitation has to apply to all shareholders equally. It cannot be made in regard to PLCs whose shares are traded in a regulated market.

[33] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 798, 802, based on similar conclusions of the German law.
[34] Companies Act, 273.
[35] High Commercial Court in its decision of 29 May 2007, Pž-7766/06-3, published in ING-Pregled sudske prakse, No 1/2008, para 2, p 8-9. Cited in: Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 833.
[36] Companies Act, 273.
[37] Supreme Court, 2 November 2005, Revt-48/05. Cited in: Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 835.
[38] Companies Act, 291 (1),

2.3 Directors' liability within the group of companies (Konzern)

Croatian law specifically addresses the duties and liability of controlling shareholders in a corporate group context. The Companies Act defines the "corporate group" or "concern" (*"koncern",* which derives from the German *"Konzern"*) as a connection between two or more companies, usually a parent and subsidiary, where such companies are jointly managed.[39] There are several types: contractual concern, factual concern and concern by integration. Under certain conditions the parent company is liable to the subsidiary company, its shareholders or creditors, and directors of both companies are liable to the subsidiary.

2.3.1 Contractual concern of companies

Contractual concern is created by the contract on management of the company's business or the contract on transfer of entire profits. Under the first contract one company (subsidiary) entrusts its whole management to another (parent company). Under the latter, the subsidiary is obliged to transfer its entire profits to the parent company. They are considered as "organisational" contacts and are in detail regulated by Companies Act.[40] The parent company is obliged to cover all losses of its subsidiary, which arise throughout the duration of the contract, unless they can be covered from the company reserves. Those contracts have to envisage an appropriate fee which has to be paid to shareholders of a subsidiary company. Also, the parent company has to take over the shares from the subsidiary company's shareholders, if they require so, and pay them an appropriate severance fee. The severance fee can be either in shares of the parent company or in money.[41]

In regard to the contract on management of the company's business, the Companies Act has special provisions on liabilities of directors of both companies. This is a consequence of the fact that a parent company can give mandatory instructions, even if those instructions are harmful to the subsidiary, as long as they are in its interest or the interest of some other company from the same group of companies.[42] Directors of the parent company are liable for the damage to the subsidiary if they have not applied the care of a prudent businessman. Any shareholder of the subsidiary company can make a claim on behalf of the company. A claim can also be made by creditors of the subsidiary if the subsidiary cannot satisfy their claim. Directors of the subsidiary company are jointly and severally liable with directors of the parent company if they have in any way breached their duties. They are not liable if the damage was caused by a mandatory instruction from the parent company.[43]

2.3.2 Concern by integration

If all shares of a company are held by another company, the general meeting of a subsidiary can render a resolution on integration of those two companies. The general meeting of the parent company has to accept the integration.[44] Integration can take place also if a parent company has the shares which represent 95% of the share capital of the subsidiary. From the moment of the registration of integration in the court register, the remaining shares are transferred to the parent

[39] Companies Act, 476.
[40] Companies Act, 479-492.
[41] Companies Act, 491, 492.
[42] Companies Act, 493.
[43] Companies Act, 494, 495.
[44] Companies Act, 503.

company and the minority shareholders of the subsidiary are entitled to an appropriate severance fee.[45]

From the moment of the integration's registration, the parent company is jointly and severally liable to creditors of the subsidiary for all obligations of subsidiary, notwithstanding the fact whether obligations have arisen before or after the integration.[46] The parent company can give mandatory instructions to the subsidiary even if this is not in the parent company's interest (unlike in the contractual concern). Directors of the parent company are liable for the damage to the subsidiary, incurred by their actions, if they did not exercise the care of a prudent businessman. Any shareholder of the subsidiary company can make a claim on behalf of the company. A claim can also be made by creditors of the subsidiary if the subsidiary cannot satisfy their claim. Directors of the subsidiary company are jointly and severally liable if they have in any way infringed their standard of care.[47]

2.3.3 Factual concern of companies

The factual concern exists if two companies are subjected to a single system of management, but it is neither contractual nor based on integration.[48] In such case the parent company cannot influence the subsidiary in a way which causes damage to it, unless it undertakes an obligation to compensate all damages which result from such influence.[49] If the parent company causes the damage to the subsidiary it has to compensate that damage by the end of the business year or it has to give the subsidiary company a claim for the compensation of damages. If it does not do so, the parent company is jointly and severally liable together with its directors, if they have given the instructions to the subsidiary. Any shareholder of the subsidiary company can make a claim on behalf of the company. A claim can also be made by creditors of the subsidiary if the subsidiary cannot satisfy their claim. The directors of the subsidiary are jointly and severally liable if they omit to report the damages in their report on the group of companies. Again, the standard of care is the same; that of a prudent businessman.[50]

[45] Companies Act, 504.
[46] Companies Act, 506.
[47] Companies Act, 507.
[48] Jakša Barbić, *Pravo društava, knjiga prva – opći dio* (3rd edn, Organizator Zagreb 2008), p 650/651.
[49] Companies Act, 496.
[50] Companies Act, 501, 502.

3 THE SCOPE OF DIRECTORS' DUTIES UNDER CROATIAN LAW

3.1 Types of directors' duties

3.1.1 Duties of the management board

Most important competences of the management board and its directors are:

1. Management of the PLC's business. This is the most important duty since it includes all activities aiming at the realisation of the company's purpose. The management board manages the PLC's business independently and at its own risk.[51] In reaching decisions directors have to take into account the best interests of the company from an objective point of view. Interests of the company are not the same as the interests of the majority or even all shareholders. This means that directors have to take care primarily of the profitability of the future business, even if this means lower profits in a short term. Directors have to manage the business with the care of a prudent businessman and they are limited by the customary business practices.

   The management board can make decisions either in the meetings or outside of them. If there is more than one director, the management board has to reach decisions unanimously. The consent of other directors can be given impliedly.[52] The articles of association can provide for some other method of management, even that each director manages the business individually, but they cannot provide that a minority can pass a decision against the majority's will.[53]

2. PLC's representation. Representation of a PLC is an external expression of business management that encompasses the PLC's relationship with third persons, especially conclusion of contracts. Therefore, the same principles of company's interest, care of a prudent businessman and customary business practises are applicable.

   Principles of decision-making are also similar. If the management board has several directors they are only authorised to represent the PLC jointly. The articles of association or the decision of the supervisory board, if so provided in the articles of association, can prescribe a different method of the PLC's representation, even that each director represent the PLC individually. On the other hand, third persons' actions have effect as long as they have been manifested to at least one member of the management board.[54]

3. Convening the general meeting when it is in PLC's interest[55] and assisting it. The management board is obliged to:
   - Prepare the resolutions which are within the general meeting's competences, at its request;

[51] Companies Act, 240 (1). The independence of the management board is adequately ensured by the rule that its members can be removed only if there exists an important reason. Also, the supervisory board and the General Board are not authorized to give mandatory instructions.
[52] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 749.
[53] Companies Act, 240 (2).
[54] Companies Act, 241.
[55] Companies Act, 277 (1).

- Prepare the contracts which cannot be entered into without the consent of the general meeting; and
- Enforce the resolutions brought by the general meeting.[56]

4. Reporting to the supervisory board. The management board has to inform the supervisory board on:
    - The business policy and other principle issues regarding the future management of business (at least once a year unless a change of condition or new matters necessitate an immediate report);
    - Profitability of the PLC's business, especially the profitability of use of the PLC's own capital (at the Supervisory Board's meeting where annual financial reports are discussed);
    - The course of business, particularly profits and the state of the company's affairs (at least once in three months);
    - Business activities which could have a substantial impact on the profitability and solvency of the PLC's business (sufficiently early to allow the supervisory board to take a position regarding these issues); and
    - Any other information upon the request from the supervisory board or any of its members.[57]

5. Reporting to the general meeting. The management board reports the following:
    - The annual report on the state of the PLC's affairs, which has to be submitted once a year. *Companies Act* prescribes its mandatory content. If a PLC has shares which are traded on a regulated market, a part of that report is PLC's statement on the implementation of the code of the corporate governance;
    - The consolidated annual report, which is submitted by the management board of a parent PLC with its seat in the Republic of Croatia, and it encompasses the state of affairs of that company and its subsidiary companies. It corresponds to the annual report on the state of PLC's affairs;
    - Annual financial reports. In their composing, directors have to apply the rules on accounting. The management board refers them to the supervisory board where they are examined by the auditors. Finally, they are delivered to the general meeting; and
    - The proposition of distribution of the profits. It is submitted together with the annual financial reports and it contains the opinion of the management board on how the PLC's profits should be distributed.

3.1.2 Duties of the supervisory board

Most important competences of the management board and its directors are:

1. The supervision of the management of the PLC's business and reporting to the general meeting in that regard.[58] The supervisory board is within its competences independent from the influence of the general meeting and it has to act in the best interest of the PLC, with the care of a prudent businessman. The supervision of PLC's management does not include only reviewing of the measures already undertaken, but also the supervision *ex ante* by setting the PLC's general business strategy. However, this should never be in such degree to interfere with the managing function entrusted to the management board. The articles of association can prescribe that for certain actions of the management board, the consent of the supervisory board is necessary. If

[56] Companies Act, 243.
[57] Companies Act, 250.
[58] Companies Act, 263 (1), (3).

the consent is refused, the management board can refer to the general meeting which can give consent with the majority of ¾ of votes.[59] The supervisory board is authorised to review the accounts and the documents on the company business, its treasury, securities and other.[60]

2. The appointment and removal of the management board. The supervisory board is a body through which the shareholders control the work of the management board. This is due to the fact that the supervisory board is entitled to appoint and remove its members. Such control is limited, since members of the management board can be removed only if an important reason exists.[61]

3. The representation of the PLC towards the management board. Although the PLC's representation is a competence of the management board, if some of its directors file a claim on the nullity or voidability of resolutions of the general meeting, the PLC will be represented by the supervisory board.[62]

4. Convening of the general meeting. The supervisory board can convene the general meeting when it deems appropriate and each time when it is in the interest of the PLC. Such decision is made with a majority of votes of its directors.[63]

5. It is the duty of the supervisory board to ensure that the management board, in the report on the PLC's affairs, provides information on the mandatory or voluntary code of corporate governance which PLC applies; on practices of corporate governance; if PLC deviates from those codes or practices; measures of internal supervision and risk management; some other information relevant for the public.

3.1.3 Duties of the board of directors, executive directors and officers

The board of directors consists of non-executive and executive directors. While the former primarily supervise the PLC's activities, the latter manage its business together with the executive officers appointed by the board of directors. Most important competences of the board of directors are as follows:

1. The management of the PLC[64] which is a somewhat different notion than the management of the PLC's business entrusted to the management board.[65] Management of the PLC implies setting the general framework of company business and making the long-term entrepreneurial decisions. The board of directors defines the strategies which the PLC has to follow in its everyday business. On the other hand, the executive directors acting together with the executive officers manage the PLC's business in its day-to-day activities. They can act only within the limits set by the board of directors' decisions. Executive directors and officers also represent the PLC.[66]

2. Establishing the basis for conducting objects of the company.[67]

[59] Companies Act, 263 (5).
[60] Companies Act, 263 (2).
[61] Companies Act, 244.
[62] Companies Act, 263 (2).
[63] Companies Act, 263 (4).
[64] Companies Act, 272.h (1).
[65] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 1006.
[66] Companies Act, 272.m.
[67] Companies Act, 272.h (1).

3. Supervising the management of the PLC's business.[68] The board of directors has to undertake the supervision of the PLC´s management in a similar fashion as it is done by the supervisory board. However, some differences are necessary since the management is conducted by the board of directors itself, and it has to supervise its own actions.

4. The appointment and removal of the executive directors and officers.[69]

5. Representation of the PLC in regard to the executive directors and officers.[70]

6. Reporting to the general meeting[71] the same reports which are the competence of the management board in a two-tier structure: the annual report on the state of PLC's affairs, the consolidated annual report and annual financial reports.

3.1.4 Duty of care

As already explained, the duty of care is a universal duty of all directors since it describes the method by which all other duties (competences) have to be conducted. Moreover, it applies equally to the directors of the management board, supervisory board, board of directors and executive officers. It is emphasised in certain situations in which it is particularly important, such as the liability of directors in the group of companies (see above) or in the process of merging two companies.

Section 252(1) of the Companies Act 252 (1) reads:[72]

> *The management board members shall manage the business of the company with the care of a prudent businessman and shall keep business secrets of the company. A member of the management board does not act contrary to the due care if he, in making of the entrepreneurial decision, may reasonably assume, based on appropriate information, that he acts in the best interest of the company.*

The first sentence of this provision provides for the standard of care of a prudent businessman, and the second sentence provides for the so-called "business judgment rule".

It is considered that the care of a prudent businessman means the care which would be taken by an independent entrepreneur, aware of his duties, who manages not his own, but other people's assets, in a way which would be undertaken by a person whose task is to care about financial interests which are not his own.[73] This is a wide and a flexible standard which encompasses performing other duties. In order to satisfy that standard a director must exercise at least an average degree of professional conduct, measured by objective criteria. If a director has special knowledge or abilities it has to use them.

[68] Companies Act, 272.h (1).
[69] Companies Act, 272.l (1).
[70] Companies Act, 272.h (1).
[71] Companies Act, 272.h (3), (5).
[72] Translation in English made by the reporter.
[73] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 791.

This standard is in a more general one already expressed in the general law of obligations. The Obligations Act 2005 provides that every person has to perform its obligations with the degree of care which is in legal transactions required for the kind of obligation in question. This is called “care of a good businessman”. A person who performs an obligation from his professional activity has to apply the “care of a good professional” and act in accordance with professional practices and customs.[74] Therefore, a director has to act with a care which is required from a person who manages the company’s business, especially if he has professional knowledge. However, it should be noted that the duties of a director do not arise from a contractual obligation, but directly out of the statute which regulates the role of a director.

Croatian law does not expressly provide for a duty of loyalty. However it is considered that such a duty arises out of the care of a prudent businessman, both towards the PLC and its shareholders. Loyalty means that directors’ interests always have to be subordinated to the interests of a PLC, that they have to avoid competition with it and that they have to refrain from damaging the PLC’s reputation. Loyalty also means that directors should refrain from using confidential information, acquired in the course of their duty, for their own personal needs. The prohibition of competition with the PLC is provided in the Competition Act in regard to the members of the management board and executive directors and officers in a one-tier structure. Without the consent of the supervisory board, a member of the management board (i.e. without the consent of the board of directors an executive director or officer) cannot, either for his account or for the account of others, perform activities of the PLC, act as a member of the management or supervisory board in another company engaged in business similar to that of the PLC or use PLC’s premises to conduct any business. Without such consent, the member of the management board also cannot be a member of another company or be personally liable for its obligations if that company performs the same activities as the PLC in question.[75]

Other duties that have been found[76] as arising out of the standard of care of a prudent businessman are:

- Observing the rules which regulate the internal relations in a PLC (acting within the objects of the company, respecting the competences of other bodies, complying with the statute, articles of association and rules of procedure of a certain body). The courts have found that a director has not acted with the care of a prudent businessman if he has not calculated and reported his travel expenses although the PLC had given him an instruction to do so;[77]
- Observing the rules which regulate the PLC’s relations with third persons (which includes, except company law, many other areas of law). The courts have found that a director has not acted with the care of a prudent businessman if he contracted for construction works without complying with the prescribed written form of such contract;[78]
- Duty of cooperation with other directors, especially within the same board;
- Acting with care customary in the corresponding profession; and
- Acting within the boundaries of a entrepreneurial judgment.

[74] Obligations Act 2005, 10 (1), (2).
[75] Companies Act, 248, 272.l (8).
[76] According to Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 791.
[77] Commercial Court, Osijek, of 22 May 2001, P-249/01, published in ING-Pregled sudske prakse, No 2/2003, para 2, p 13. Cited in: Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 792.
[78] High Commercial Court of 19 February 2008, Pž-527/04, published in Izbor odluka Visokog trgovačkog suda Republike Hrvatske, No 14, November 2008, p 119-121, decision No 56. Cited in: Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 792.

It can be concluded that the standard of a prudent businessman is a common denominator for many duties which arise out of the director's function. It always has to be assessed in accordance with the situation in which it is observed and, therefore, it is difficult to make any conclusive remarks. It should also be noted that such standard of due care differs in regard to the members of different boards. The management board's directors and the executive directors and officers have the widest scope of duties since they manage the business on the everyday level. On the other hand, non-executive directors of the board of directors and the supervisory board are engaged in the PLC's affairs only periodically. What is prudent for a businessman who runs a business only from time to time is not necessarily prudent for a businessman who is constantly active.

3.1.5 Business judgment rule

In the Companies Act the business judgment rule is formulated in a way that it interprets what is considered under the notion of due care. Therefore, it is not a duty separate from due care, but a special aspect of it. It was introduced in order to provide for a wider margin of unconstrained entrepreneurial decision-making, since the standard of a prudent businessman could be interpreted as too burdensome for directors. Interpreting s 252(1) of the Companies Act, legal commentators have identified the following requirements for the application of the business judgment:[79]

1. That it is an entrepreneurial decision, i.e. a decision within the entrepreneurial discretion and not a duty required by the law. While rendering such decision, directors have to act in accordance with the rules which regulate their conduct (statute, the articles of association, rules of procedure and their contract with PLC). However, this does not necessarily apply to compliance with the PLC's obligations vis-à-vis third persons (i.e. a breach of contract between PLC and a third party can be an entrepreneurial decision). The business judgment rule is not applicable to due care of members of the supervisory board, since the making of entrepreneurial decisions is not within their competences.

2. Directors must reasonably believe that they act in the best interests of the PLC. This includes making decisions which disregard short term profits of a PLC in order to achieve future stability and the value of enterprise. Interest has to be that of a PLC and not of a majority or even all shareholders.

3. The decision must not be one which incurs an excessive risk. Whether a decision is too risky is assessed on the basis of an average care required in a certain profession including professional skills of an average director.

4. The decision has to be based on appropriate information. Whether information is appropriate is assessed on the information available at the time when the decision was made and not afterwards. The amount of information gathered has to be proportional to the importance of the decision. If long-term strategic decisions are in question, only detailed information will be deemed appropriate.

5. Directors who render a decision must not be in a conflict of interest. Although the statute does not prescribe this requirement it arises out of the duty of loyalty to PLC.

[79] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 794-796. The business judgement rule was introduced into Croatian law by amendment of the Companies Act in 2007 (Official Gazette 107/2007), and the amendment has come into force on 1. April 2008. So far, there are no court decisions relating to the business judgement rule. Due to the the German law-roots of Croatian company law, the discussion in the literature of the requirements set out below relies heavily on German jurisprudence in this area.

6. Directors must render a decision in good faith.

3.1.6 Duty of confidentiality

In the same sentence with the standard of care of a prudent businessman, the Companies Act 252(1) mentions the duty to “keep business secrets of the company”. The duty of confidentiality includes all confidential information and secrets about the PLC’s activities and its clients. For information to be confidential it is not necessary that it is declared as such. It encompasses all facts which are publicly not available and are known only to an exclusive circle of authorised persons. Confidential information is also not limited to that which directors learn independently in the course of their duty. It includes everything that directors hear from their clients, other directors or from other sources. Duty of confidentiality continues after the expiration of a director’s mandate.

The duty of confidentiality does not bind in regard to other directors, even those from different boards, committees of the PLC, auditors, parent company in a concern, persons who conduct due diligence procedure, when it is in the interest of the PLC. The duty also does not exist in regard to shareholders within the scope of their right to be informed of the PLC’s affairs or in regard to the public authorities within their public duties.[80] However, directors may refuse to testify in court on certain issues if there is an important reason,[81] which includes the business secret.

The notion of business secrets has its statutory basis in the Act on Protection of Confidential Information 1996.[82] That Act also specifies which information cannot be a business secret, who has an obligation to keep the secret confidential and under which conditions it is possible to disclose the business secret. Some specialised statutes provide for the confidentiality of directors of PLCs with particular functions. According to the Act on Credit Institutions 2008 directors of a bank are supposed to keep bank secrets.[83] Duties of confidentiality are also provided for directors of the stock exchange, central depository and clearing company, investment firms and insurance companies.[84] Apart from civil liability, the Companies Act also introduces the criminal offence of disclosing a business.[85]

3.1.7 Duties in the vicinity of bankruptcy

The Companies Act provides that if the management board finds out in the process of issuing financial reports, other reports or in any other way that the loss in the PLC amounts to a half of the share capital, it has to convene the general meeting immediately and notify it of such loss.

If a PLC cannot pay its debt when it is due (cash flow insolvency) or its debts exceeds assets (balance sheet insolvency), the management board has to request the initiation of bankruptcy proceedings immediately, or at latest three weeks after an event which is designated by a special statute as a reason for initiating bankruptcy proceedings. After the cash flow or balance sheet insolvency occurs,

[80] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 798.
[81] Act on Civil Procedure 1991 (Zakon o parničnom postupku), Official Gazette No. 53/91, 91/92, 58/93, 112/99, 88/01, 117/03, 88/05, 02/07, 84/08, 123/08, 57/11.
[82] Zakon o zaštiti tajnosti podataka, Official Gazette No. 108/96, especially article 19.
[83] Zakon o kreditnim institucilama, Official Gazette No. 117/08, 74/09, 153/09, articles 168, 169.
[84] Capital Market Act, 293, 519, 54 (2), Insurance Act 2005 (Zakon o osiguranju), Official Gazette No. 151/05, 87/08, 82/09, articles 137, 138.
[85] Companies Act, 629.

the management board has to suspend all payments, except those which can be paid with the care of a prudent businessman.[86] In the one-tier structure, this is the competence of the board of directors. Executive directors and officers only have the duty to notify its president.[87]

Those provisions, as well as the provisions of the Bankruptcy Act, will be analysed in detail in a separate section of this report (see section 5 below). Here it will suffice to notice that the standard of a prudent businessman again plays an important role.

3.2 To whom are the duties owed?

Directors owe their duties primarily to the PLC in whose boards they are members. However, indirectly, the duties are also owed to the PLC's creditors and shareholders, since, under certain conditions, they have a claim against directors.

3.3 The director as a shareholder

Duties apply equally to all directors, irrespective of whether they are at the same time the PLC's shareholders or not. The position of a shareholder and that of a director are separate functions and even if they are performed by the same person, they should still be separated in terms of legal consequences. Also, all duties discussed in this report are cumulative, especially since they principally arise out of the same general standard of care. Naturally, directors of a certain board are entrusted only with the competences of that board. For example, a member of a supervisory board does not have a duty to manage the company business. Only in that sense, the duties of a certain board are alternative.

In their capacity as shareholders, directors may generally exercise voting rights from shares they hold in the same manner as any other shareholder. In particular, directors are not generally bound to exercise voting rights in the interest of the company. According to Companies Act, 293 (1), however, a director cannot vote on matters relating to the formal approval of that director's actions. Furthermore, no shareholder may exercise voting rights where the vote relates to a waiver of liability or any other claims of the company against that shareholder. The latter prohibition therefore prevents a shareholder-director from waiving or limiting his own liability vis-á-vis the company. Directors may, however, vote in their capacity as shareholders regarding their own board appointment.[88]

3.4 The time span of the duties

Duties and liabilities of directors begin from the moment when their appointment takes effect and last until expiry of their mandate or their removal or resignation. Duration of duties and liabilities does not depend on the contract between the PLC and director[89]. For *de facto* directors, duties and liability would probably last as long as they act as directors without the objection from the body which was

[86] Companies Act, 251.
[87] Companies Act, 272.h (4), 272.l (4).
[88] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 552.
[89] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 802.

supposed to appoint them. A person who deliberately influences other directors and causes damage to the PLC (notion which corresponds to the shadow director, see section 2.3) is liable for each such influence.

3.5 Application of duties to *de facto* and shadow directors

In Croatian law directors' duties are primarily aimed at *de jure* directors. *De facto* directors are a notion that has not yet been dealt with, either by statutes or by the case law. Only the jurisprudence comments that their existence should be recognised and that the same standards for de jure directors should be applied (see section 2.2.1).

For shadow directors (i.e. the closest notion in Croatian law), it is necessary that they cause the damage deliberately (see section 2.2.2). Since their intent is needed, there is no need for an encompassing standard such as that of a prudent businessman. Shadow directors are liable not only to the PLC, but also directly to shareholders if any damage occurred to them independently from the damage caused to the PLC and to its creditors if they cannot satisfy their claim from the PLC.[90]

4 Liability for breach of duty

In the Companies Act liability of directors is envisaged as a consequence of the breach of duties from Article 252 (1) – which are, as explained, duty of care, including the business judgment rule and the duty of confidentiality. Directors' liability is also regulated in a universal way. If a director fails in any of his duties he would also fail in the duty to act as a prudent businessman and, consequently, be liable for it. Even the duty of confidentiality is no exception. It could be said that the liability is a universal consequence of an action which was performed differently from the conduct of a prudent businessman. Therefore, in Croatian law there is only one liability with one set of conditions.

The general rule is that directors who breach their duties are jointly and severally liable for the damage caused to the PLC.[91]

4.1 Conditions for liability

The PLC's director is liable to the persons designated by the statute if he is culpable for his actions which cause a loss to the PLC.

4.1.1 Culpability

Directors are liable for any kind of culpability, which means even for negligence. In Croatian law a rule of general law of obligations is that when someone causes loss to another person, his negligence is presumed and he has the burden of proof to prove otherwise.[92] This is also true for the liability of

[90] Companies Act, 273 (1), (4).
[91] Companies Act, 252 (2).
[92] Obligations Act 2005, 1045. On the other hand, for liability which requires a higher standard of culpability, gross negligence or intent are never presumed and they have to be proven by the party who claims liability.

directors and expressly recognised by the Companies Act and supported by the case law.[93] Consequently, for a PLC to claim damages it is sufficient to prove three other requirements for director's liability: action, loss and causation.

The required culpability is different if the claim is made by the PLC's creditors. Directors are liable only if they breach their duty of care with gross negligence.[94] Gross negligence is not presumed and it has to be proved by the creditors. However, there are exceptions according to which culpability of directors is presumed even in regard to creditors. The Companies Act provides that directors are particularly liable for damages if they, contrary to the provisions of that Act:

- Return to shareholders what they have contributed into the share capital;
- Pay interests or dividends to shareholders;
- Subscribe, acquire, take as a lien or redeem the PLC's own shares or another company's shares;
- Issue shares before the value for which they were issued or a higher value has been fully paid;
- Distribute PLC's assets;
- Make payments after the occurrence of the cash flow or balance sheet insolvency;
- Give a compensation to the members of the supervisory board;
- Give a credit; or
- By conditional increase of share capital, issue shares contrary to its purpose or before contributions have been fully paid up.[95]

This applies equally to claims made by PLC or its creditors. However, in regard to creditors, those situations shift the burden of proof on directors that they have acted with due care. In regard to the PLC they have no such effect since directors are already liable for negligence and the burden of proof is on them.

As already explained, in order for a person who influences directors to cause damage to the PLC and a person who profits from such action to be liable, they have to act deliberately.[96] A person who makes such a claim has to prove it since the existence of intent is never presumed.

4.1.2 Action which causes a loss to PLC

Considering the fact that negligence is presumed, in order to succeed with its claim the PLC has to prove only; (a) that it suffered damage; (b) the director's action or omission and (c) that action or omission caused the damage.[97] These are the usual requirements for the compensation of damages and they are not different for directors' liability than for other areas of civil law. Damage is not only a decrease of the existing assets (so-called "ordinary damage" or *damnum emergens*) but also preventing of the increase of the future assets (lost profits or *lucrum cessans*).[98] Causation is determined on the basis of what is called "adequate causation". This means that not every event and

[93] Companies Act, 252 (2). High Commercial Court in its decision of 29 January 2008, Pž-7909/05, published in Izbor odluka Visokog trgovačkog suda Republike Hrvatske, No 15, December 2009, decision No 51. Cited in: Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 818.
[94] Companies Act, 252 (5).
[95] Companies Act, 252 (3).
[96] Companies Act, 273 (1), (3).
[97] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 802.
[98] Obligations Act, 1046.

action in the causal chain is considered to cause damage, only those which typically produce a certain result. Action or omission has to be proved in regard to the director which is being sued. Actions of other directors cannot be attributed to him.[99]

If directors undertake one of the actions enumerated in the Companies Act (see above, no. 2, on culpability), it is presumed that loss occurred and that it was caused by such action.[100] In that case it is sufficient for the PLC to prove the action and the burden of proof for all other requirements for liability (negligence, loss, causation) is on the directors.

4.2 Exemptions and limitations

As already explained, in Croatian law duties of directors arise primarily out of statute and not out of contract. Consequence is that their liability is a statutory liability and exemptions are possible only in a strict number of situations provided in the statute. This has an additional justification in regard to creditors who cannot be deprived of their rights by a contract between the PLC and its directors.

Statutory provisions on liability are mandatory and they cannot be altered by the articles of association or the contract with directors. The Companies Act provides that directors are not liable if their actions were based on a resolution rendered by the general meeting. On the other hand, approval of the supervisory board does not exclude liability.[101] The resolution of the general meeting does not exempt from liability if it is null or void or if it was based on erroneous information given by directors. In addition, since the directors' actions have to be "based on general meeting's resolution", the general meeting's ratification of directors' former activities has no effect.[102]

Also, directors are exempt from liability under already mentioned provisions of groups of companies (see section 2.4). Directors of a subsidiary company are not liable if they have received mandatory instructions from the directors of the parent company, based on the contract on management of the company's business or on integration of two companies.[103] Liability is also excluded on the grounds of mandatory instructions of a parent company in the factual concern of companies, if the loss is compensated to subsidiary company in the course of the business year or if the subsidiary company acquires a claim against the parent company for compensation of damages.[104]

Not only that the liability of directors cannot be excluded in advance, before the action that caused loss occurred, but the statute also strictly limits the allowability of the waiver or settlement of an already existing claim. The PLC may waive its claim for compensation of the damage or negotiate a settlement only upon the expiry of three years after the claim originated, and only if the general meeting gives its consent and there is no objection from the minority shareholders which hold shares representing at least one-tenth of the share capital, and their objection is not entered into the records

[99] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 819.
[100] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 801.
[101] Companies Act, 252 (4).
[102] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 804. However, there has been one case in which it was ruled otherwise.
[103] Companies Act, 493 (1), 507 (1).
[104] Companies Act, 496 (1).

of the general meeting. The three years' time limit is not applicable if the person liable for the damage is insolvent, or if that person, in order to avoid bankruptcy, settles with his creditors.[105]

In regard to the claim of the creditors directors are not exempt even if their actions were based on a general meeting's resolution. Also, a waiver or settlement made by the PLC has no effect on the creditors' claim.[106] The rationale of those provisions is that creditors are third persons who should not be deprived of their rights by the PLC's conduct.

To sum up, in Croatian law the liability of directors can be excluded only based on the statute – *ex ante* by a resolution of the general meeting and *ex post* only if the conditions for waiver and settlement are satisfied. Ratification is not possible. Mandatory instructions within the group of companies also exempt from liability, but only in the sense that instead of the subsidiary company's directors, directors of the parent company are liable.

4.3 Insurance against liability

Unlike for some other professional activities the director's insurance against liability has not been designated by the statute as mandatory[107]. Therefore, directors can insure their liability on a voluntary basis, in accordance with the general rules of the law of obligations which govern the insurance from liability[108]. The object of such insurance contract is the directors' duty of care, i.e. the duty to manage the PLC with the care of a prudent businessman[109]. The insurer will be liable for the damage caused by the covered risk only if the third person, to which the damages have been caused, claims compensation[110].

4.4 Consequences of liability

The general rule is that directors who breach their duties are jointly and severally liable for the damage caused to the PLC. Directors who have not breached the care of a prudent businessman are not liable at all. Those who have breached their duties are jointly and severally liable which means that the PLC (i.e. shareholders or creditors) can collect damages from all or only some of them. This is conducted in accordance with the general law of obligations.[111] Each debtor who is jointly and severally liable is liable up to the full amount of the claim. After the person who made a claim is satisfied, directors have the right of recourse among themselves. How much each director is eventually going to pay is established in proportion with his culpability and the severity of consequences arisen out of his conduct. If contributions of individual directors cannot be determined, each is liable for an equal part of the claim, unless the reasons of fairness dictate otherwise.

[105] Companies Act, 252 (4).
[106] Companies Act, 252 (5).
[107] Hrvoje Vojković, *Osiguranje od odgovornosti članova uprava, nadzornih odbora i prokurista trgovačkih društava*, Zbornik pravnog fakulteta u Zagrebu, Nr. 58, 2008., p 1025. E.g. statutes have prescribed mandatory insurance for the following professions: lawyers (attorneys), public notaries, architects, auditors.
[108] Obligations Act 2005, 964, 965.
[109] Hrvoje Vojković, *Osiguranje od odgovornosti članova uprava, nadzornih odbora i prokurista trgovačkih društava*, Zbornik pravnog fakulteta u Zagrebu, Nr. 58, 2008., p 1036.
[110] Obligations Act 2005, 964 (1).
[111] Obligations Act 2005, 1109.

Directors who breach their duties and cause a loss to the PLC are liable for the compensation of damages.[112] This is discernible from the provisions on liability which mention the compensation of damages.[113] Directors' actions are not null or void only because they caused damage to PLC. They could be null or void only if particular prerequisites for the invalidity are fulfilled (e.g. if directors act outside the scope of their authority).

[112] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 802.
[113] E.g. Companies Act, 252 (4).

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 The meaning of 'vicinity of insolvency'

As long as their mandate lasts, directors are obliged to perform their duties with the care of a prudent businessman. This includes the time period after the PLC becomes insolvent and the bankruptcy proceedings have commenced. However, the vicinity of insolvency creates some additional duties.

The notion of "vicinity of insolvency" will be used in order to cover situations envisaged by the Companies Act and the Bankruptcy Act, which will be explained in more detail below. It includes the PLC's loss which amounts at least to the half of the share capital and the PLC's insolvency up to the commencement of the bankruptcy proceedings.

5.2 Change of existing duties

The existing duties do not change, at least not from the legal point of view. As explained, the general standard is that of a prudent businessman, aided with the business judgement rule. That is a flexible standard which allows for different interpretations in the different circumstances. When the insolvency approaches a prudent businessman would certainly act in a different manner than before. However, it falls under the same general duty of care. Anything more specific would have to be decided on a case-by-case analysis.

5.3 Newly arising duties

The Companies Act envisages directors' duties in the vicinity of insolvency in Article 251. This article refers only to duties of the management board, but it is equally applicable to the board of directors.[114] Executive directors and officers only have the obligation to inform the president of the board of directors about the reasons which constitute the vicinity of insolvency.[115] Directors of the supervisory board have no special duties in this regard, but they should supervise all activities of the management board, including those pertaining to insolvency. The Bankruptcy Act contains similar obligations in the vicinity of insolvency and it specifies what is considered under the notion of insolvency.

5.3.1 Duty of convening the general meeting

The Companies Act provides that if the management board finds out in the process of issuing financial reports, other reports or in any other way that the loss in PLC amounts to a half of the share capital, it

[114] Companies Act, 272.h, 4.
[115] Companies Act 272.l, 4.

has to convene immediately the general meeting and notify it of such loss.[116] Although the loss of a half of the share capital does not necessarily mean that the PLC will become insolvent, it is certainly an indicator that business is not going well and that insolvency may endanger the PLC's future business.

This provision is only a specification of the more general management board's duty to convene the general meeting when it is provided by the statute or the articles of association and whenever it is in the interest of the PLC.[117] The general meeting has enough powers (e.g. to distribute the profits, to elect members of the supervisory board and the board of directors) to try to prevent future losses and the occurrence of the insolvency. Also, convening of the general meeting is the most common way to inform shareholders on the state of the PLC's affairs.

5.3.2 Duty of requesting the commencement of the bankruptcy proceedings

The central duty of directors in regard to the insolvency is to request the commencement of the bankruptcy proceedings. The Companies Act envisages this duty in two situations. First, when the PLC is not able to pay its debts when they are due (so-called cash flow insolvency) and when the PLC's debts exceed its assets (balance sheet insolvency). The management board has to request the commencement without delay or at the latest three weeks after the occurrence of an event which is designated by a special statute as a reason for initiating the bankruptcy proceedings.[118]

Bankruptcy Act contains almost the same provision, according to which the management has to propose the commencement of the bankruptcy proceedings without delay or at latest twenty one days after the PLC's inability to pay its debts or after debts exceed its assets.[119] The Bankruptcy Act elaborates what is considered under cash flow and balance sheet insolvency.

A debtor is unable to pay his debts if he cannot, on a permanent basis, pay his financial obligations when they fall due. The fact that a debtor has fully or partially paid or is able to pay claims of certain creditors does not automatically mean that he is able to pay his debts.[120]

It is considered that a debtor is unable to pay if, in a time period longer than 60 days, unpaid obligations, for which a valid legal basis exists, are registered at the bank which conducts his payment operations and which should be paid from any of the debtor's accounts even without his further approval. The fact that in that time period the debtor had money in other bank accounts from which all claims could have been satisfied does not mean that he is able to pay his debts.[121] This presumption will not apply if the debtor satisfies all due claims in the course of the initial proceedings or if a third person declares that he is liable together with the debtor (accession to debt). The debtor can prove that claims have been satisfied only by a public or publicly authenticated statement by the institution who deals with payment operations.[122]

[116] Companies Act, 251 (1).
[117] Companies Act, 277 (1).
[118] Companies Act, 251 (2).
[119] Bankruptcy Act, 4 (10).
[120] Bankruptcy Act, 4 (3).
[121] Bankruptcy Act, 4 (4).
[122] Bankruptcy Act, 4 (5).

A debtor is overindebted when his existing obligations exceed his assets. A debtor will not be considered as overindebted if, according to the circumstances of the case, it can be reasonably assumed that in his further course of business he will be able to satisfy his obligations when they fall due.[123]

The Bankruptcy Act also provides for a sanction if directors neglect their duty. If directors do not propose commencement of the bankruptcy proceedings, they are personally liable to the creditors for any damage they cause them.[124] This provision diverges from the Companies Act provisions on liability. As already explained, according to the Companies Act, the PLC itself has the ability to seek compensation for a breach of directors' duty whereas the creditors can only seek compensation from directors personally when their claims cannot be satisfied by the PLC. Even then, the creditors' claim is of an accessory nature, since they are only allowed to effectuate claims which belong to the PLC (see section 4.2, point 1). However, the Bankruptcy Act gives a direct claim to the creditors which have suffered damage as a consequence of a directors' omission. This is a reasonable solution because in the context of bankruptcy proceedings the creditors are most likely to suffer damage and they have a prevailing interest to claim damages elsewhere and not only from the PLC who is already insolvent.

Other requirements for claiming damages are the same as for the breach of other duties. The person claiming damages has to prove the omission of a director, loss and causation. Negligence is presumed and the burden of proof is on a director that he did not act negligently.[125] This additionally indicates that the creditors' claim provided by the Bankruptcy Act is not the same as creditors' claim provided for in the Companies Act. According to the Companies Act, directors are liable to creditors generally only if they breach their duties with gross negligence, which has to be proven by creditors (see section 4.2, subsection 2). Difference in the degree of culpability between those two claims has been confirmed by the case law.[126]

5.3.3 Duty of suspending all payments

The Companies Act provides that after the cash flow or balance sheet insolvency occurs, the management board has to suspend all payments, except those which can be paid with the care of a prudent businessman.[127] The care of a prudent businessman is the same standard as for the conduct outside of insolvency, but in this particular context it is applied differently. The general rule is that all payments have to be suspended and in that way the rights of the creditors are being preserved as far as possible. Particular circumstances may allow for the payments even after the insolvency occurs, however, this is an exception which has to be interpreted in strictly and allowed only when it is really necessary. This is an example of how the standard of a prudent businessman is flexible. Payments which would be ordinarily conducted by a prudent businessman in the normal course of business may become unreasonable in the circumstances of insolvency.

[123] Bankruptcy Act, 4 (8).
[124] Bankruptcy Act, 39 (8).
[125] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 828.
[126] High Commercial Court in decision of 15 February 2007, Pž-7739/04-3. Cited in: Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 821. Also decision by High Commercial Court of 29 January 2008, Pž-7909/05, published in Izbor odluka Visokog trgovačkog suda Republike Hrvatske, No 15, December 2009, decision No 51.
[127] Companies Act, 251 (3).

6 Enforcement of duties

6.1 Who has standing to sue

6.1.1 The company as plaintiff

Bringing of an action against a director and representation of the PLC

Directors are liable primarily to the PLC.[128] Directors' duties arise out of a relationship with the PLC, which is created from the moment of directors' appointment (or a corresponding event in the case of *de facto* directors). That relationship is not of a contractual nature but of a statutory and "organisational" nature. Nevertheless, the consequences of the breach of duties are similar as if they were duties arising out of contract.

In the usual course of business the PLC is represented by the management board or, in one-tier structure, by the executive directors and officers.[129] This includes bringing lawsuits and representation of the PLC in front of the court. If a claim is made against directors of the supervisory board or the board of directors, the PLC will be represented in that way. However, when directors of the management board, i.e. the executive directors or officers, are being sued, such representation is no longer allowable due to the obvious conflict of interest. For those situations the Companies Act provides that the supervisory board, i.e. the board of directors represents the PLC against the management board, i.e. executive directors and officers.[130] Therefore, the supervisory board, i.e. the board of directors should decide whether to bring a claim to court.[131]

Nevertheless, a danger exists that interests of the supervisory board, i.e the board of directors become intertwined with the interests of the management board, i.e. executive directors and officers and even with interests of majority shareholders. That is all the more possible since the general meeting elects members of the supervisory board, i.e. the board of directors with the simple majority and they appoint members of the management board, i.e. executive directors and officers. In order to prevent such a conflict of interest, the Companies Act provides in detail the possibility of a derivative action initiated by shareholders.

6.1.2 The shareholders as plaintiffs

6.1.2.1 In their own name

Directors can be primarily sued by the PLC. Shareholders are generally not allowed to bring a non-derivative action on their own behalf. However, shareholders can sue a person who deliberately influences members of the management board, supervisory board, board of directors, executive

[128] Companies Act, 252 (2).
[129] Companies Act, 241, 272.m (1).
[130] Companies Act, 268, 272.m (2).
[131] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 808.

officers or some other representative to perform an action which caused damage (see section 2.3, on shadow directors). This will be applicable only if they suffer damage independently from the damage caused to the PLC.[132] The High Commercial Court found that damage caused by decreasing the value of the shares would not be considered as damage independent from the damage to the PLC.[133] In a situation of independently caused damage, shareholders can also sue *de iure* directors if they breach their duties and a person who profited from those actions, if he participated in them deliberately[134]. They are all jointly and severally liable. Shareholders could also sue directors based on the general provisions of the obligations law.

6.1.2.2 In the name of the company ('derivative action')

Article 273.a envisages that the PLC has to make a claim against the members of the management board, i.e. executive directors and officers, if the general meeting makes such decision with a simple majority of votes, or if it is requested by shareholders whose shares represent at least one-tenth of the share capital, under the condition that they have been shareholders for at least three months before the meeting.[135] Action can be brought only within six months after the conclusion of the general meeting.

The PLC is represented in court by the body which usually represents it (the management board, i.e executive directors and officers or, if the claim is against one of them, by the supervisory board, i.e the board of directors). However, since that also carries a potential conflict of interests, the general meeting can appoint special representatives. If the general meeting decided to bring the claim or it was the initiative of shareholders whose shares represent at least one-tenth of the share capital, the court may, on the initiative of the mentioned minority or shareholders whose shares represent at least 8.000.000,00 kuna (cca. 1055.409 €), appoint different representatives if it deems that it will be useful for the PLC's success with the claim.[136]

Although the derivative action has to be made within six months from the conclusion of the general meeting, it can be brought even afterwards if there are facts which justify reasonable doubt that the PLC suffered damage by fraudulent actions or by a gross violation of the statute or the articles of association. If those facts are proved by shareholders, whose shares represent at least one-twentieth of the share capital or at least 4.000.000,00 (cca. 527.704 €), the court will appoint special representatives. Those representatives have to bring a claim on behalf of the PLC if they, on the basis of their professional judgment, assess that there is a possibility to succeed.[137]

A special kind of derivative action, with much lower requirements, is provided in the case when the claim is being made against directors of the parent or subsidiary company in the contractual concern, concern by integration or factual concern (see subsection 2.4). Any of the shareholders can sue those directors on behalf of the subsidiary company.[138]

[132] Companies Act, 273 (1).
[133] Pž-1286/04-5 of 24. January 2007. Cited in: Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 807.
[134] Companies Act, 273 (2), (3)
[135] Companies Act, 273.a (1), 272.l (9).
[136] Companies Act, 273.a (2).
[137] Companies Act, 273.a (3).
[138] Companies Act, 494 (4), 495 (3), 501 (4), 502 (4), 507 (1).

6.1.3 Creditors as plaintiff

The third category of persons who have a claim against directors and who can sue them, are the creditors of the PLC. The creditors have a claim only if they cannot satisfy their claims from the PLC itself.[139] Their claim is of an accessory nature, since they only effectuate the PLC's claim. The main requirement is that the PLC could satisfy creditors' claims, but it failed to do so and, afterwards it is objectively unable to satisfy them.[140] In order to prove that the PLC is unable to satisfy a claim it is not necessary that distrait procedure has been conducted. This can be proved also by other means, such as the blocking of the PLC's bank accounts. Although the courts previously held that distrait procedure is necessary, they have changed their practice.[141]

Notwithstanding provisions of the Companies Act, creditors can sue directors on the grounds set by the Bankruptcy Act, if they cause them damages by not proposing the commencement of the bankruptcy proceedings when they were supposed to do so (see section 5.3). In the course of the bankruptcy proceedings the creditors' rights against directors are exercised by the bankruptcy administrator (trustee in bankruptcy),[142] which includes bringing an action against them.

6.1.4 The court jurisdiction

Claims against directors made by the PLC, its shareholders or creditors are all resolved in front of the commercial court which has jurisdiction in the area where the seat of the PLC is.[143] This has been supported in the practice of the courts.[144] The Companies Act regulates the seat of a company in articles 37-39.

6.2 Criminal and administrative sanctions

In addition to the civil liability and the claim on damages, there are some other mechanisms which ensure that directors' conduct is in accordance with the law. The Companies Act provides for the criminal liability of directors. Crimes for which directors can be found liable are: giving of false information,[145] false presentation of assets,[146] breach of duty in the event of loss, overindebtedness or insolvency,[147] breach of confidentiality.[148] Directors can also be liable for certain misdemeanours[149] and the registry court can issue them penalties if they do not comply with the warning to fulfil their obligations in regard to the registration in the court register.[150]

[139] Companies Act, 252 (5), 273 (4).
[140] Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 813. Although the High Commercial Court decided that it is not necessary that PLC could ever satisfy its claims (19 November 2002, Pž-5916/00, published in Zbirka rješidbi hrvatskih trgovačkih sudova, No 7, p 67, decision No 43).
[141] Decision by a High Commercial Court of 5 September 2006, Pž-8360/03, published in Izbor odluka Visokog trgovačkog suda Republike Hrvatske, No 12, p 136-137, decision No 66. Cited in: Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 814.
[142] Companies Act, 252 (5), 494 (4), 495 (3), 501 (4), 502 (4).
[143] Act on Civil Procedure 1991, 34.b, (3), (4).
[144] Supreme Court, Grt-497/02, 17. July 2002. published in Informator, No. 5255-5256, 17. and 21. July 2004., p 4. Cited in: Jakša Barbić, *Pravo društava, knjiga druga – društva kapitala, svezak I, Dioničko društvo* (5th edn, Organizator Zagreb 2010), p 807.
[145] Companies Act, 624.
[146] Companies Act, 625.
[147] Companies Act, 626.
[148] Companies Act, 629.
[149] Companies Act, 630 (2).
[150] Companies Act, 632 (2).

The Criminal Act 1997[151] sanctions certain conduct characteristic for the position of a director, although other persons can also commit those crimes. Those crimes are particularly: preferential treatment of creditors,[152] abuse of the bankruptcy and of the bankruptcy procedure,[153] infringement of the obligation to maintain commercial and business records,[154] tax evasion,[155] embezzlement,[156] violation of intellectual property rights and unauthorised use of company name,[157] creating of the monopolistic position in the market[158] and some others.

Directors can also be effectively sanctioned by their removal from their function. Members of the management board can be removed only if an important reason exists and one of the important reasons enumerated by the statute is their gross breach of duty.[159] Members of the supervisory board can be removed with the ¾ of votes given in the general meeting if the articles of association do not provide for a higher majority. They can be also removed by the court, on the initiative of the supervisory board or shareholders whose shares represent at least one-tenth of the share capital or at least 8.000.000,00 kuna (cca. 1055.409 €), if an important reason exists.[160] Members of the board of directors can be removed under the same conditions as members of the supervisory board.[161] Executive directors and officers can be removed by the board of director's decision, even without an important reason. A different solution can be provided for in the articles of association.[162]

[151] Kazneni Zakon, Official Gazette 110/97, 27/98, 50/00, 129/00, 51/01, 111/03, 190/03, 105/04, 84/05, 71/06, 110/07, 152/08, 57/11.
[152] Criminal Act, 281.
[153] Criminal Act, 282, 283.
[154] Criminal Act, 287.
[155] Criminal Act, 286.
[156] Criminal Act, 293.
[157] Criminal Act, 293.
[158] Criminal Act, 288.
[159] Companies Act, 244.
[160] Companies Act, 259, 260.
[161] Companies Act, 272.e.
[162] Companies Act, 272.l (6).

7 CONFLICT OF LAWS

7.1 Classification under Croatia's private international law

In Croatian law all questions pertaining to the incorporation and internal organisation of a PLC (or any other company) are decided in accordance with a single law, the so-called *lex societatis*. *Lex societatis* governs a PLC's legal personality, standing in court, structure, status, rights and obligations of shareholders and bodies, representation and termination.[163] Although directors enter into a contract with a PLC, as already explained, their duties and functions are a part of the PLC's mandatory structure, set by the statute. Therefore, the law applicable to duties and liabilities of directors is not law applicable for their contract (*lex contractus*), but the *lex societatis*.

The *Act on Resolution of the Conflict of Laws with Regulations of Other Countries in Certain Relations 1991* (hereinafter: *Act on Resolution of the Conflict of Laws*)[164] provides that a legal person is governed by the law under which it was constituted. However, if the actual seat of a legal person is in a country different from the one where it was constituted and that country recognises it as its legal person, it will be governed by the law of that country.[165] This means that Croatian law primarily adopts the incorporation theory and alternatively, under certain conditions, the seat theory. The *Companies Act* provides that all commercial companies, including PLC, are legal persons.[166] Consequently, the law of the country of its incorporation will be applicable as *lex societatis* on its organisation including duties and liabilities of directors. If and when the law of the actual seat would be applicable is decided in accordance with the rules which regulate the company's seat, in case of Croatian law, *Companies Act.*[167] Croatian law's reliance on the incorporation theory is also visible from the Companies Act provisions on the foreign investments. A foreign investor is considered any legal person whose registered seat is located outside the Republic of Croatia and any natural person who is a foreign citizen, refugee or stateless person, insofar as he acquires shares or business shares in a company or makes investments on a contractual basis.[168] Under the presumed condition of reciprocity those foreign investors can invest in Croatian companies under the same conditions as domestic persons.

Lex societatis governs all directors' duties and liabilities, irrespective of the fact whether they are provided by the company law or some other legal area. Even if some duties arise out of the obligations law, as long as they pertain to the function of director (and not his obligations outside the PLC), *lex societatis* should still be applicable.

7.1.1 Special duties in the vicinity of insolvency

Lex societatis equally applies to duties in the vicinity of insolvency, all the more so since they are provided in the Companies Act as well. However, Bankruptcy Act contains a special conflict of laws provision that bankruptcy proceedings and its effects are governed by the law of the country where the

[163] Jakša Barbić, *Pravo društava, knjiga prva – opći dio* (3rd edn, Organizator Zagreb 2008), p 377.
[164] Zakon o rješavanju sukoba zakona s propisima drugig zemalja u određenim odnosima, Official Gazette No. 53/91, 88/01.
[165] Act on Resolution of the Conflict of Laws, 17.
[166] Companies Act, 2 (1).
[167] Companies Act, 37-39.
[168] Companies Act, 619 (1).

proceedings have been commenced (so-called *lex loci concursus*), unless that Act provides otherwise.[169]

This calls for delineation between directors' duties in the context of insolvency and effects of the bankruptcy proceedings. In regard to directors' liability to the PLC, the centre of legal relations lies in a relationship between the PLC and directors who owe them duties. The insolvency is only a circumstance which gives rise to certain obligations which are always extraneous to the bankruptcy proceedings themselves. Therefore, *lex societatis* will be applicable.

However, the situation is different in regard to directors' liability to creditors. As already mentioned (see section 5.3), the claim to which Bankruptcy Act authorises creditors is of a different nature than the creditors' claim provided by Companies Act. Company law authorises creditors only to make an accessory claim against directors, i.e. to effectuate PLC's claim against directors if their own claims against PLC cannot be satisfied. On the other hand, if directors breach their duty to initiate bankruptcy proceedings, the Bankruptcy Act in Article 39 (8) envisages a creditors' claim which is not derived from the PLC's claim. The culpability required from those two Acts is also different: while the Companies Act requires gross negligence, the Bankruptcy Act requires ordinary negligence.

This means that creditors' claim from the Bankruptcy Act is not based on the PLC's nature, its organisation and relationship with creditors, but on the provisions which aim to protect the creditors in the context of bankruptcy. Therefore, those claims should be considered as "effects of the bankruptcy proceedings" and governed by *lex loci concursus.*[170]

[169] Bankruptcy Act, 303.

[170] Since the applicable law for those claims has not been established in practice or in jurisprudence, this is the opinion of the reporter, based on the analysis of those provisions.

8 CONCLUSION

Croatian law regulates directors' duties and liability primarily in the company law, but also in other legal areas which deal with directors' activities, such as the law on obligations or the bankruptcy law. Directors are persons who have been appointed as members of the PLC's bodies (*de iure* directors). Presumably they could also be *de facto* directors, but that situation has not yet been dealt with. Liability of the persons who deliberately influence *de iure* directors to cause the damage to the PLC or its creditors is a functional equivalent to the notion of shadow director. Provisions of the group of companies also shift the usual liability and, under certain conditions, make both directors of the parent and the subsidiary company liable for the damage incurred to the subsidiary.

Directors' competences are provided throughout the Companies Act, but the due care with which they have to be preformed is regulated in a universal way as a standard of a prudent businessman. Many other duties, such as duty of loyalty are derived from that duty. The business judgment rule is also formulated in a way that it interprets the standard of due care. The vicinity of insolvency gives rise to specific duties such as the duty of convening the general meeting, duty of requesting the commencement of the bankruptcy proceedings and the duty of suspending all payments.

PLC is primarily authorized to make a claim and to sue directors since they are members of its bodies. Shareholders can sue in a limited number of situations and the claim of the creditors is only an accessory of the claim of PLC. Bankruptcy Act provides for an individual claim of the creditors if directors do not propose the commencement of the bankruptcy proceedings when they were supposed to do so. The person who brings an action usually has to prove only directors' action or omission, its loss and the causal nexus between the two. Negligence is sufficient to trigger liability and it is presumed, so the burden of proof lies on directors that they have applied the care of a prudent businessman. A difference exists only in regard to a creditors' claim since creditors have to prove directors' gross negligence. Companies Act enumerates certain situations for which directors are particularly liable and in which the loss and causation, as well as the gross negligence are also presumed.

Considering that directors' liability is based on statute and not on their contract with the PLC, it is not possible to exclude or limit their liability or to ratify their actions. Directors can be exempt only for the reasons provided in the statute – if their actions were based on a prior resolution of the general meeting. Even a waiver or a settlement of the claim against directors is possible only in strictly prescribed situations.

Due to the potential conflict of interest between directors who are sued and those who sue them on behalf of PLC, company law provides for the possible derivative action initiated by shareholders. Apart from initiating an action shareholders can also appoint special representatives in that lawsuit or require the court to appoint them.

Such extensive regulation covers all the important aspects of directors' duties and liability. It is coordinated with other legal systems in envisaging some sophisticated legal mechanisms, such as the liability of persons who control *de iure* directors; liability of other companies and their directors within a group of company; business judgment rule; special duties in the vicinity of insolvency; derivative action initiated by shareholders. The standard of due care is sufficiently flexible to adapt to most of the new situations which can occur. However a more extensive case law would be welcomed which could establish at least the main typical situations in which directors' liability can be recognized.

DIRECTORS’ DUTIES AND LIABILITY IN CYPRUS

Initial author: Eleni Papasozomenou

CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in Cyprus

The Cypriot legal system is highly reflective of the island's turbulent history. Cyprus, "contrary to its size and population has an extensive legal history".[1] The Mycenaneans, Achaeans, Phoenicians, Assyrians, Egyptians, Persians, Alexander the Great, the Romans, Byzantines, Crusaders, Lusignans, Venetians, Turks and British have all, in turn, conquered and exercised control over Cyprus and its inhabitants and influenced the legal system of the island at the time of their control.[2] The British rule was, however, the most influential on the legal system. The island of Cyprus was a part of the British Empire from 1878-1960, during which time the English legal system was introduced and the laws that were enacted applied the common law and equity doctrines.

In 1960, after Cyprus independence, the English legal system was largely preserved on the island. A number of factors made the preservation of the English legal system necessary. The main reasons were that it was a legal system accepted by both the Greek Cypriot and the Turkish Cypriot communities as the island's system of law, and the lawyers of both communities who applied the law were mostly graduates of English educational institutions. The English legal system was the one they were mostly proficient in.[3] The Cypriot legal system could now be described as a "mixed legal system"[4] in which the legal structure is widely based on English law, with a few exceptions where the European Continental tradition is followed. Key areas of the law such as contract law, tort, criminal and evidence are replications of the respective English laws. However, the Continental principles of administrative law, according to which the legality of administrative decisions can be judicially reviewed, have been introduced and applied by virtue of Article 148 of the Cypriot Constitution.

Pursuant to section 29(1)(b) of the Courts of Justice Law (14/1960), all courts apply the Constitution of the Republic, the laws which have been retained by virtue of Article 188 of the Constitution, the principles of common law and equity, and the English laws which were applicable in Cyprus before 1960.[5] This means that courts have to base decisions on the applicable legislation in the relevant field, taking into account the key principles of common law and equity. This has played a primary role in the evolution of different areas of law in Cyprus. Cyprus Company Law, particularly the area of directors' duties, is no exception.

1.2 Corporate landscape in Cyprus

Cyprus Companies Law, CAP 113 of the Law of Cyprus, is largely based on the 1948 Companies Act of the United Kingdom and is almost a duplication of that law. However, the Law does not follow the later amendments made to the United Kingdom Companies Acts, but has been adjusted to the Cypriot

[1] Alexandros Markides, Attorney General of the Republic of Cyprus Foreword in: "Introduction to Cyprus Law" by Andreas Neocleous & Co.
[2] Andreas Neocleous and David Bevir "Legal History" in: "Introduction to Cyprus Law" by Andreas Neocleous & Co.
[3] Rikkos Mappourides "Introduction to the Cypriot Legal System" –«Εισαγωγή στο Κυπριακό Νομικό Σύστημα».
[4] Symeon C. Symeonides "The Mixed legal system of the Republic of Cyprus, the first Worldwide Congress on Mixed Jurisdictions: Salience and Unity in the Mixed Jurisdiction Experience: Traits, Patterns, Cultures, Commonaliies" 78 Tulane Law Review 441 (2003-2004).
[5] "The common law must be planted here as a living growth which can be pruned by judicial decision to suit local conditions (because).... the intention of the country's legislator was the service of people in this country" Paikkos v Kontemeniotis (1989) 1.C.L.R 50 at 73. See also Protopapas v Gunther (1974) 10 J.S.C 981.

Legal System and European Union Law. The Law was enacted in 1951 and 39 amendments have been adopted since then. Although there is statutory legislation in the field of Company Law, Chapter 113 of the Laws of Cyprus, common law and equity principles play an essential role in the interpretation of the law, especially in the area of directors' duties and liability in Cyprus.

Cyprus Companies Law, CAP 113, is the main body of corporate legislation for the incorporation and operation of all companies in the Republic of Cyprus.[6] It regulates the formation, management and dissolution of companies. As stated above, the law follows the principles applicable in English law in the field. Although Cyprus Companies Law, CAP 113, mainly treats public and private companies in the same way, public companies are under a stricter control by the Registrar of Companies as their functions "affect and concern their entire membership and this may mean thousands of company investors".[7] This stricter control is further reflected in the duties and responsibilities of directors of the two different types of company. The directors of public companies are under more stringent scrutiny by the law and face stricter liability in cases of breach of their duties, as will be seen below.

The Companies Law, and common law and equity principles cover the duties of directors of private companies exhaustively. Directors of public limited companies, especially those listed on the Cyprus Stock Exchange, also have to act in conformity with the following corporate governance legislation:

- The Cyprus Corporate Governance Code,[8] which must be applied by all companies listed on the Cyprus Stock Exchange;
- The memorandum and articles of association of the company, which prescribe the powers and the internal regulations of the company. Table A of the Companies Law contains a set model of articles of association for public limited companies, which can be adopted either in full or in part by the company;
- The Cyprus Stock Exchange Laws and Regulations N 14(I)/1993 (as amended);
- The Cyprus Securities and Exchange Commission Establishment and Responsibilities Law (Law 64(I)/2001);
- The Inside Information and Manipulation of the Market (Abuse of the Market) Law 2005 (Law 116(I)/2005);
- The Law Providing Transparency Requirements (Law 190 (I)/2007) (Transparency Law);
- Investment Services and Activities and Regulated Markets Law of 2007; and
- European Union legislation.

It may be viewed as an "anomaly"[9] that the Cyprus Companies Law does not give a precise definition of a public company. Instead, the Law contains a definition of the private limited company. Given that the Law specifically defines a private company, it may readily be concluded that a public company is a corporation which does not constitute a private company. According to the Law, a private company is a company which by its articles of association specifically:

- Restricts the right to transfer its shares;[10]
- Prohibits the issue of bearer shares;[11]

[6] Dr K Chrysostomides & Co LLC Chryso Pitsilli-Dekatris and Stelios Hadjilambris, "Chapter 8: Cyprus" in "The International Legal Guide to Corporate Governance 2011: a practical cross-border insight to corporate governance" published by Global Legal Group.
[7] "Corporate Law" Elias A. Neocleous, Kyriakos Georgiades and Markus Zalewski in: "Introduction to Cyprus Law" by Andreas Neocleous & Co., p. 319.
[8] Cyprus Corporate Governance Code (Third Edition) March 2011.
[9] "Corporate Law" Elias A. Neocleous, Kyriakos Georgiades and Markus Zalewski in: "Introduction to Cyprus Law" by Andreas Neocleous & Co.
[10] Cyprus Companies Law, CAP 113, Section 29 (1)(a).
[11] Cyprus Companies Law, CAP 113, Section 29 (1) (d).

- Prohibits any invitation to the public to subscribe for its shares or debentures;[12] and
- Limits the number of its members to 50, not including persons who are in the employment of the company, and persons who having been formally in the employment of the company, and who have continued after the termination of that employment to be members of the company.[13]

It thus follows that if any one or more of the above four prerequisites is missing from the articles of association of a company, it cannot be registered as a private company. In addition, this also means that deletion of one of the prerequisites from the company's articles after incorporation has the effect that it must comply with the requirements of a public company.[14]It must also within fourteen days deliver to the Registrar of Companies for registration a statement in lieu of a prospectus in the relevant form containing the particulars set out in Part I of the Third Schedule of the Law. A public company may, after complying with the relevant requirements, obtain a stock exchange listing. Such a listing can be in Cyprus or abroad.

According to the Companies Law, public limited companies need to comply with specific obligations. These are:

- The minimum number of members of the company must be seven with no maximum number applicable[15] (in cases where members of a company become less than seven for more than six months, the members become personally liable for the debts and liability of the company);[16]
- A public company must have at least two directors;[17]
- If directors are appointed by the company's articles, the consent of these directors must be filed with the Department of Registrar of Companies and Official Receiver on incorporation;[18]
- A public company must have a statutory meeting and its directors must present a statutory report to its members;[19]
- A public company must obtain a trading certificate from the Registrar of Companies before it can commence business;[20]
- Only public companies may issue share warrants;[21]and
- A public company must issue a prospectus or a statement in lieu of prospectus before issuing any of its shares or debentures to the public.[22]

Table A of the Cyprus Companies Law regulates the internal affairs of public limited companies. This includes the appointment and powers of directors, voting rights of members and shareholders, the conduct of meetings and details relating to the accounts of the company. The company's memorandum can conform partly or wholly with Table A. Section 4(5) of the Cyprus Companies Law states that a public company's articles of association must include rules setting out the number of

[12] Cyprus Companies Law, CAP 113, Section 29 (1)(c).
[13] Cyprus Companies Law, CAP 113, Section 29 (1)(b).
[14] "Corporate Law" Elias A. Neocleous, Kyriakos Georgiades and Markus Zalewski in: "Introduction to Cyprus Law" by Andreas Neocleous & Co.
[15] Cyprus Companies Law, CAP 113, Section 3(1).
[16] Cyprus Companies Law, CAP 113, Section 32.
[17] Cyprus Companies Law, CAP 113, Section 171.
[18] Cyprus Companies Law, CAP 113, Section 175(1).
[19] Cyprus Companies Law, CAP 113, Section 124(1).
[20] Cyprus Companies Law, CAP 113, Section 104 (1).
[21] Cyprus Companies Law, CAP 113, Section 8 and 107.
[22] Cyprus Companies Law, CAP 113, Section 48 (1).

directors of the company, the method of their appointment, and may include rules stating the manner in which functions will be distributed among the directors.[23]

1.3 The board of a Cypriot company

All companies in Cyprus are managed by a one-tier board structure. The members of the board of directors act and are liable collectively.[24] The Cyprus Companies Law does not distinguish between non-executive, supervisory or independent directors and consequently all are treated the same under the Law. However, the board of directors in public limited companies in Cyprus is composed of both executive directors, who in effect are professional executives with skills in the particular area of business, and non-executive directors who are not involved in the day-to-day running of the company's affairs. The directors may delegate their powers to the chief executive officer (CEO) or to committees of the directors who are accountable to the board, must implement its policies and decisions, and may have a chairman who is appointed by the directors.[25] The articles of association may lay down the rules in relation to board meetings and voting rights. For example, the articles may determine whether the chairman has a second or a casting vote in case of equality of votes in board decisions. The articles usually provide that the business of the company shall be managed by the directors and they may pay all the expenses of the promotion and registration of the company as well as exercise the powers of borrowing money, charge or mortgage the company's undertakings and property, as provided in Table A of the Companies Law.

In relation to listed public limited companies the Corporate Governance Code provides that "every listed company should be headed by an effective board of directors which should lead and control the company."[26] It further states that "the board of directors should include a balance of independent non-executive directors and remaining directors, such that no individual director or small group of directors can dominate the board's decision making."[27] The Code provides that non-executive directors should have sufficient abilities, knowledge and experience so that their opinions carry significant weight in the board's decision making. In non-listed companies non-executive directors should comprise not less than one third of the board of directors, whereas in listed companies 50% of the directors should be non-executive directors, excluding the chairman.[28] As the Code states, "[i]f this requirement is not met, at least one third of the directors must be independent non-executive directors and additionally the company must give an explanation in the Company's annual report why the number of not independent non-executive directors exceeds 50% and submit an application to the Council of the Cyprus Stock Exchange for a reasonable time period for compliance with the above requirement. The Council of the Cyprus Stock Exchange may approve the Company's application for compliance, for each case separately, but this shall not in any case exceed the period of twelve months."[29] The Code further stipulates that the independent non-executive directors should be listed in the annual report of the Company and the board should specify whether the independence criteria laid down in the Code are met.[30]

[23] Cyprus Companies Law, CAP 113, Section 4(5).
[24] Dr K Chrysostomides & Co LLC Chryso Pitsilli-Dekatris and Stelios Hadjilambris, "Chapter 8: Cyprus" in "The International Legal Guide to Corporate Governance 2011: a practical cross-border insight to corporate governance" published by Global Legal Group.
[25] Dr K Chrysostomides & Co LLC Chryso Pitsilli-Dekatris and Stelios Hadjilambris, "Chapter 8: Cyprus" in "The International Legal Guide to Corporate Governance 2011: a practical cross-border insight to corporate governance" published by Global Legal Group.
[26] Corporate Governance Code (Third Edition) March 2011, Article A.1.
[27] Corporate Governance Code (Third Edition) March 2011, Article A.2.
[28] Corporate Governance Code (Third Edition) March 2011, Article A.2.3.
[29] Corporate Governance Code (Third Edition) March 2011, Article A.2.3.
[30] Corporate Governance Code (Third Edition) March 2011, Article A.2.3.

The Code sets a number of minimum criteria that a non-executive director should meet.[31] However, it further states that if these criteria are not met but the board of directors nevertheless considers that the director is independent, a comprehensive explanation of the reasons for this assessment should be given in the company's annual report on corporate governance.[32] The criteria for a director's independence are listed in the Code.[33]

According to the Corporate Governance Code companies should establish three committees of the board, namely the nomination committee, the remuneration committee, and the audit committee. The Code proposes that the nomination committee should be set up to make recommendations to the board on all new appointments.[34] The majority of the members of this committee should be non-executive directors and its chairman should either be the chairman of the board or a non-executive director.[35] The chairman and the members of the nomination committee have to be identified in the company's annual report of corporate governance.[36] The remuneration committee should be comprised exclusively of non-executive directors.[37] It should submit recommendations to the board in accordance with pre-agreed terms of reference regarding the framework and the level of remuneration for executive directors. [38] The audit committee should have at least two non-executive directors; its duties are to continuously review the scope and results of the audit, its cost-effectiveness, and the independence and objectivity of the auditors.[39]

1.3.1 Ownership structure/State controlled companies

There are 31 state-controlled companies in Cyprus, most of which were established after independence in 1960. These companies may be divided into two broad groups:

a) Statutory corporations established by or under specific legislation which are legal entities whose capital is wholly granted through state funds (e.g. Broadcasting Corporation (CyBC)) and
b) Limited liability companies established under company law where the government has the controlling interest (majority holding of shares in the company). These amount to six and they are listed on the Stock Exchange (e.g. Cyprus Airways PLC).

Statutory corporations are operated by management boards appointed by the Council of Ministers for a specific term of office, which is usually five years, i.e. the term of years that each government is in power. The board determines the company's policy and is responsible for its general administration. Board members include government representatives and private individuals with commercial and financial knowledge or expertise in the relevant fields. Although the board functions independently of the government, it is accountable to the respective minister. All statutory state controlled companies are required to follow policy guidelines as laid down by ministers or the government.

[31] Corporate Governance Code (Third Edition) March 2011, Article A.2.3.
[32] Corporate Governance Code (Third Edition) March 2011, Article A.2.3.
[33] Corporate Governance Code (Third Edition) March 2011, Article A.2.3.
[34] Corporate Governance Code (Third Edition) March 2011, Article A. 4.1.
[35] Corporate Governance Code (Third Edition) March 2011, Article A. 4.1.
[36] Corporate Governance Code (Third Edition) March 2011, Article A. 4.1.
[37] Corporate Governance Code (Third Edition) March 2011, Article B. 1.1.
[38] Corporate Governance Code (Third Edition) March 2011, Article B. 1.1.
[39] Corporate Governance Code (Third Edition) March 2011, Article C. 3.1.

In contrast to statutory state-controlled companies, limited liability companies controlled by the state are managed according to the memorandum and articles of association of each company. Appointment and removal of the members of the board is made by the council of ministers and the board is responsible to the shareholders, be it the government or others. Board membership is mixed and government representatives oversee compliance with the company's policy.

1.3.2 Shareholders and the company's board

The Companies Law leaves certain matters to the shareholders' competence and decision. These are: the change of the company's name or objects; amendments to the company's memorandum and articles of association; increase and reduction of the authorised share capital; mergers involving the company; and the appointment and removal of directors. This is not an exhaustive list and the promoters may elect to widen the statutory powers of the shareholders by shifting management powers from the board of directors to the shareholders. However, this is not usual for public limited companies, particularly for listed public limited companies.[40]

1.3.3 Employee participation

According to Cyprus Company Law, employees do not have a specific role to play in the management of the public limited company and the appointment of directors. However, Cyprus has implemented Directive 94/45/EC on the establishment of a European Works Council. This establishes notification and consultation rights for employees of union scale undertakings and groups.[41]

[40] Dr K Chrysostomides & Co LLC Chryso Pitsilli-Dekatris and Stelios Hadjilambris, "Chapter 8: Cyprus" in "The International Legal Guide to Corporate Governance 2011: a practical cross-border insight to corporate governance" published by Global Legal Group.
[41] Council Directive 94/45/EC of 22 September 1994 on the establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of informing and consulting employees.

2 The concept of 'company director' in Cyprus

2.1 *De jure* directors

The Cyprus Companies Law does not define the term director, but section 2(1) provides that a "director includes any person occupying the position of director by whatever name called."[42] Similarly, it was established in the English case *Ferguson v Wilson*[43] that directors are agents of the company for which they act.

According to the Companies Law, public limited companies must have a minimum of two directors[44] and one secretary.[45] Although the directors of a company can exercise all of the powers of the company, except powers which are specifically prohibited and restricted by law and the memorandum of the company, the law imposes some restrictions on the appointment of directors for public limited companies. According to Section 175 of the Cyprus Companies Law, in the case of public companies, a director (who has to be appointed in accordance with the articles of association, or on registration of the company by the promoters, or before being named as a director in any prospectus) must file with the Department of Registrar of Companies and Official Receiver his consent to be a director, and the company must file a list of all such persons named as directors.[46]

The Cyprus Companies Law does not specify the means of appointing directors but leaves this to the articles of association of the company. In practice, the articles of association provide for "initial appointment by the subscribers to the memorandum and thereafter for the annual retirement of a certain proportion and the filling of vacancies at an annual general meeting".[47]

In relation to public limited companies, section 177 of the Law provides that a company's general meeting cannot decide on a motion for the appointment of two or more directors in a single resolution, unless this is unanimously agreed to in a meeting. Section 178(1) provides specifically that any director may be removed from office by an ordinary resolution of the company notwithstanding anything in the articles or any agreement between the company and the director. This provision eliminates the concept of a life director. The only exception to the rule exists with respect to directors who held office for life before 16 February 1951 (the date on which the Companies Law came into force).

[42] Cyprus Companies Law, CAP 113, Section 2(1).
[43] Ferguson v Wilson (1866) LR2 Ch 77.
[44] Cyprus Companies Law, CAP 113, Section 170.
[45] Cyprus Companies Law, CAP 113, Section 171.
[46] Cyprus Companies Law, CAP 113, Section 175.
[47] "Corporate Law" Elias A. Neocleous, Kyriakos Georgiades and Markus Zalewski in: "Introduction to Cyprus Law" by Andreas Neocleous & Co.

Directors can further be classified as *de jure*, *de facto* and shadow directors. According to the case law, company directors and company representatives shall act on the company's behalf where they are authorised to do so.[48]

The requirements to be classified as a *de jure* director are:

- The director has been appointed to the office of director according to rules governing this;
- The person has agreed to hold office;
- The person is not disqualified from being a director; and
- The person has not vacated the office.

The Law does not impose any requirement that the director must be a natural person and thus it can be the case that another company is appointed as a director of a company. This was first held in the common law case *Re Bulawayo Market and Offices Co Ltd.*[49]

2.2 *De facto* and shadow directors

A director who is not a *de jure* director may be considered a *de facto* director. The concept of *de facto* directors is provided for in the Cyprus Companies Law. Section 174 of the Law states that the actions of company directors or managers bind the company, notwithstanding any defect in their appointment or qualification. The section has been interpreted by the courts in a number of cases.[50] The courts have specified and stressed that a third party or a member can assume that a person who appears to be duly appointed and qualified is a director.[51] This is also the case for a director appointed at a meeting of which insufficient notice had been given.

The Companies Law makes a brief reference to shadow directors. Article 187(10)(b)(i) of the Law states that "any person on whose advice or instructions the directors of the company are accustomed to act shall be deemed to be a director of the company" and thus should be liable for negligence to keep a record of the shares held by the directors of the company. This approach of the Cyprus Companies Law is very similar to the approach taken by the UK Companies Act, which defines a shadow director as "a person in accordance with whose instructions or directions the directors are accustomed to act".[52] The UK Companies Act, however, excludes from the definition persons who give their advice in a professional capacity.[53]

48 A.D Hotel & Catering Ltd v Takis Pilava (1982) 1 CLR 81.
49 Re Bulawayo Market and Offices Co Ltd (1907) 2 Ch 58.
50 Liopetri Transport Co v Loucas Costantinou (1971) 1 CLR 424; Georgios Demetriou v Cyprofrota (1974-7) 9 JSC 847; A.D Hotel & Catering Ltd v Takis Pilava (1982) 1 CLR 81; Paneuropean Insurance Co Ltd v Νίκου Χειμάρη (Nikou Chimari) (2004) 1Β ΑΑΔ 713.
51 Liopetri Transport Co v Loucas Costantinou (1971) 1 CLR 424; Georgios Demetriou v Cyprofrota (1974-7) 9 JSC 847; A.D Hotel & Catering Ltd v Takis Pilava (1982) 1 CLR 81; Paneuropean Insurance Co Ltd v Νίκου Χειμάρη (Nikou Chimari) (2004) 1Β ΑΑΔ 713.
52 UK Companies Act, Section 251(1).
53 UK Companies Act, Section 251(2).

3 THE SCOPE OF DIRECTORS' DUTIES UNDER CYPRIOT LAW

The duties, responsibilities and powers of directors of private and public companies are substantially the same in Cyprus. Company directors have a duty to act competently, which arises from the relationship of trust existing between the company and its directors, i.e. the fiduciary duties directors owe to the company. Cyprus company law does not distinguish between the duties and obligations that executive and non-executive directors owe to the company. On the contrary, directors owe their duties severally as individuals and collectively as the board of directors. The directors are liable on a collective basis in the event that they unanimously resolve to adopt the relevant decision against the interests of the company or act in concert in order to harm the company.Such collective liability may not apply to a director who expressly objects to such a decision and takes the necessary steps to protect the company under his duty to act in good faith in the best interests of the company.

In relation to listed companies, the Corporate Governance Code states that "the board of directors should function on the basis of the principle of collective responsibility and no category of its members should absolve itself from the responsibility towards another category."[54]

Cyprus Law takes a shareholder-centred view of the company. This is demonstrated in the Cyprus Corporate Governance Code, which sets out principles of corporate governance in the interest of the company's shareholders. It clearly states that "the aim of the proposed regulations is to strengthen the monitoring role of the board of directors in listed companies, protect small shareholders, adopt greater transparency and provide timely information as well as sufficiently safeguard the independence of the board of directors in its decision-making."[55] Directors are thus seen as the representatives of the shareholders and the company is managed by the directors for the benefit of the shareholders.

3.1 Types of directors' duties

In Cyprus the fiduciary duties owed by the directors to the company are partly statutory and partly founded in case law. Both statutory and fiduciary rights are mentioned in Table A of the Companies Act, with which the company's articles of association and memorandum may correspond wholly or partially, depending on the decision of the shareholders when they incorporate the company. It is important to note that these duties are cumulative. A breach of duty may give rise to civil and criminal liability.

3.1.1 Statutory duties

The Cyprus Companies Law codifies a number of duties imposed on directors and provides sanctions for breaches. These duties mainly relate to record keeping, the preparation of financial statements and

[54] Cyprus Corporate Governance Code (Third Edition) March 2011, Section A.1.9.
[55] Cyprus Corporate Governance Code (Third Edition) March 2011, Introduction.

disclosure requirements. The duties of directors of listed companies are also stated in the Corporate Governance Code.[56]

Financial reporting

Company directors need to ensure that the company complies with its financial reporting requirements as codified in the Companies Act. Section 141 of the Companies Act[57] imposes the obligation on directors to ensure the proper keeping of books of account to enable the drawing up of financial statements in accordance with the law, as well as the obligation to ensure that the books give a true and fair view of the company's affairs.

In addition, Article 142 of the Companies Act imposes the duty on directors to ensure that a full set of financial accounts are drawn up for the company according to the International Accounting Standards. Section 142(2) requires these financial accounts to be published within 18 months after the company's incorporation and thereafter once every calendar year.[58]

Duty to disclose

Directors face strict reporting and notification requirements regarding their dealings with the company under the Cyprus Companies Law. Section 187 requires companies to keep a register of the director's shareholdings; section 188 requires disclosure of the director's salary, pension payments, and other emoluments, and section 189 provides that the company's accounts shall contain particulars showing the amount of any loans made during the financial year to any officer of the company, including the directors. Pursuant to section 190, directors are under a duty to notify the company of matters relating to themselves that are relevant for complying with above sections. Non-compliance and a failure to make the necessary disclosures required by the law may result to a fine of up to 427.50 EUR under the Companies Law. In relation to listed Companies, the Corporate Governance Code requires that the details of directors' loans should be included in the company's report on Corporate Governance.[59] In addition, administrative fines may be imposed under the Cyprus Securities and Stock Exchange Law of 1993 in relation to a failure to file a notification of acquisitions or disposals of listed securities which cross certain holding thresholds.[60]

Conflicts of interest – Declaration of interest in contracts by directors

Section 191 of the Cyprus Companies Law codifies an aspect of the fiduciary duty of directors to avoid conflicts of interest. The company's directors are in a fiduciary position with regard to the company and the company's property. As a consequence, they are prohibited from personally benefiting from their position as director and their personal interest shall not come into conflict with their duties towards the company. Section 191 imposes a duty on directors who are directly or indirectly interested in a contract or proposed contract with the company to declare the nature of their interest at the board meeting considering the transaction. If the director becomes interested in the contract after the contract is entered into, he or she must declare the interest at the first meeting of the board of directors after he/she became interested. Failure to do so constitutes a criminal offence and the director is liable to a fine of 855 EUR. Of relevance to section 191 is the judgment of the Supreme

[56] Corporate Governance Code (Third Edition) March 2011, Articles C-D, Annex 1-3.
[57] Cyprus Companies Law, Section 141.
[58] The Company is also obliged to disclose the items required by the Transparency Requirements for Issuers of Securities on a Regulated Market Law 190(I) of 2007. These include a half-yearly financial report (Section 10 of Transparency Requirements for Issuers of Securities on a Regulated Market Law 190 (I) of 2007), an interim management statement (ibid., Section 11) and quarterly reports in specific cases (ibid., Section 12).
[59] Corporate Governance Code (Third Edition) March 2011, Article C.2.3.
[60] Cyprus Securities and Stock Exchange Law, Section 171.

Court in *Giannakis Pelekanos and others v Andreas Pelekanos*, Civil Appeal No. 10953 (2006) 1A S.C.J. 390, where the Supreme Court upheld the first instance judgement of the District Court to the effect that the failure of the company directors to declare the nature of their interests prior to entering into the transaction, by using the machinery and personnel of the company pursuing projects in which they had indirect interests and by purchasing property, constituted an infringement of both the articles of association of the company and of section 191.

The provision of this section is repeated in Regulation 84(1) of Part I Table A of the Cyprus Companies Law, which can be adopted in the articles of association of the company. Further Regulation 84(2) provides that a director shall not vote in respect of any contract or arrangement in which he is interested, and if he shall do so his vote shall not be counted, nor shall he be counted in the quorum present at the meeting of the board of directors, with certain exceptions. Only the general meeting of shareholders can release the director of this prohibition, either generally or in relation to a particular contract or transaction (Regulation 84(2)). Although Part I of Table A relates to public companies, Part II of Table A, which deals with private companies, clearly states, via Regulation 1, that the Regulation of Part I Table A are applicable to private companies as well, with the exception of Regulations 24 and 53 Part I.

It is common that the articles of association of public companies include a provision which disallows the director to vote as a shareholder in the decision regarding the contract.[61] The statutory provision is in line with the common law principle that a failure by the director to comply with the statutory obligation to declare his or her personal interest does not invalidate the agreement.[62] The agreement is voidable according to the principles of equity and may be accepted by the company in general meeting.

Another statutory aspect of the above duty is encapsulated in Section 183 of the Cyprus Companies Law, which provides that it shall not be lawful for a company to make to any director of the company any payment by way of compensation for loss of office, or as consideration for or in connection with his retirement from office, without particulars with respect to the proposed payment, including the amount thereof, being disclosed to members of the company and the proposal being approved by the company.

Duty to act in cases of loss of share capital

Section 169F of the Law provides (section 169F(1) that in the event that losses of past financial years, or other reasons, lead to the reduction of the share capital of *a public company* by 50% or to a level which, as per the opinion of the directors, puts the accomplishment of the company's goal under dispute, the directors have to call, not later than 28 days from when the reduction became known to them, an extraordinary general meeting at a date not exceeding 56 days from the date when the decision for calling the meeting was made, in order to assess whether the company must be dissolved or any other measure must be taken.

Under section 169F(2), an omission by the directors of the company to act as above constitutes a tort and renders them responsible for damages. The said responsibility is personal, unlimited, joint and severable.

[61] "Chapter 8: Director's Duties" in "Company Directors" by Ch. Louka (1991) (Limassol).
[62] Aberdeen Railway Company v Blaikie Bros (1854) 1 Macq 461 (House of Lords).

3.1.2 Common law duties

As stated above, section 29(1)(b) of the Courts of Justice Law (14/1960) states that all courts shall apply the Constitution of the Republic, the laws which have been retained by virtue of Article 188 of the Constitution, the principles of common law and equity, and the English laws which were applicable in Cyprus before 1960.[63] Consequently, courts have to base their decisions on the applicable legislation in the relevant field, taking into account the key principles of common law and equity. Although English common law cases are not binding in Cyprus, they guide the Cypriot Courts, which usually adopt them.[64]

3.1.2.1 Duties of loyalty

Directors owe duties of loyalty towards the company, which stem from the fiduciary position and the relationship of trust that directors have towards the company. These duties have been recognised by the common law to be:

1. The duty to act in good faith;
2. The duty of directors to exercise their powers for the attainment of the objectives for which they were conferred; and
3. The duty of directors not to put themselves in a position where their own interest conflicts with the interest of the company without attaining the company's agreement.

3.1.2.1.1 Duty to act in good faith

One of the primary duties of the directors is the duty to act in good faith (*bona fides*) in the company's interest. This duty is subjective, i.e. the director should act in accordance with what he considers to be in the company's interest, not what a third party or the court may consider to promote the interest of the company.[65] The Court will only intervene in cases where the director takes a decision that would not have been taken by a reasonable director under the same circumstances.[66] The Supreme Court in its judgment in *Giannakis Pelekanos, as Administrator of the estate of Christophoros Pelekanos, and others v. Andreas Pelekanos and Antonis Pelekanos* Civil Appeal No. 1/2008 (2010) 1C S.C.J. 1746, citing Halsbury's Laws of England, 4th Edition, Vol. 17(1), para. 420, stated that the legal or general burden of proving a breach of the directors' duties is borne by those pleading such breach and that the burden is not reversed. However, in the event that the claimants adduce credible evidence during the proceedings which leads to prima facie conclusions as to the alleged breach, then the evidential burden will shift to the defendants, i.e. the directors' shoulders to adduce adequate evidence in order to rebut the prima facie conclusion.

In the judgment of the Supreme Court in *Giannakis Pelekanos and others v Andreas Pelekanos* Civil Appeal No. 10953 (2006) 1A S.C.J. 390, the first instance District Court judgment was upheld to the effect that the defendant directors had acted in such a way as to exclude their fellow director from the decision-making process promoting their own interests over the interests of the company, and using

[63] See Paikkos v Kontemeniotis (1989) 1.C.L.R 50 at 73: "The common law must be planted here as a living growth which can be pruned by judicial decision to suit local conditions [because] .... the intention of the country's legislator was the service of people in this country". See also Protopapas v Gunther (1974) 10 J.S.C 981.
[64] "Personal Liability according to Common Law" in "The personal liability of company directors and officials and their insurance" Miltiades Miltiadous (Nicosia, 2010).
[65] Re Smith & Fawcett (1942) Ch. 304 (C.A.).
[66] "Personal Liability according to Common Law" in "The personal liability of company directors and officials and their insurance" Miltiades Miltiadous (Nicosia, 2010).

property and personnel of the company, which constituted a breach of the duty to act in good faith for the interests of the company.

3.1.2.1.2 Duty to exercise powers for the attainment of the objectives for which they were conferred

Company Directors are under an obligation to act in accordance with the powers conferred on them by the company's memorandum. Furthermore, they have the duty to exercise these powers for the attainment of the objectives for which they were conferred.

This duty was examined by the common law courts in the case of *Howard Smith v Ampol Ltd*,[67] in which the directors issued new shares in an effort to avoid a takeover bid. The Privy Council stated that there were many good reasons why the company could issue new capital. If the main reason is the financing of the company's operations, the directors' decision does not constitute a breach of their duty, even if an ancillary effect of the capital increase is the reduction of a shareholder's relative holding. However, where the main purpose of the decision is the dilution of a shareholder's holding, the directors violate the duty to use their powers for a proper purpose.[68] In the case of *Bishopsgate Investment Management Ltd v. Maxwell*,[69] the English Court of Appeal held that the director breached his duties towards the company as he used his powers for an improper purpose. The allocation of the company's property, without receiving consideration in a private family business in which he was a director, constituted prima facie an exercise of the director's powers for the attainment of an objective for which the powers were not conferred. The director had the burden to prove the appropriateness of the transaction.

3.1.2.1.3 Duty to make independent judgments

Directors cannot enter into an agreement as to how they will use their voting rights in future board meetings or bind themselves in other ways with regard to future behaviour.[70] This prevents nominee directors from acting according to the directions of those who nominated them. Directors are obliged to make independent and unfettered judgments.

3.1.2.1.4 Duty to avoid conflicts of interest

As stated above, directors are in a fiduciary position in relation to the company. They are consequently subject to the common law duty not to put themselves in a position where the interests of the company conflict with their own interest or their obligations towards third parties.

This duty covers different situations, each of which will be explained below:

a) Directors who have a personal interest in a contract or a proposed contract with the company are under an obligation to disclose their interest; otherwise the transaction may be considered

[67] Howard Smith v Ampol Ltd (1974) A.C. 821. P.C.
[68] Personal Liability according to Common Law" in "The personal liability of company directors and officials and their insurance" Miltiades Miltiadous (Nicosia, 2010).
[69] Bishopsgate Investment Management Ltd v Maxwell (No 2) [1993] BCLC 814.
[70] "Personal Liability according to Common Law" in "The personal liability of company directors and officials and their insurance" Miltiades Miltiadous (Nicosia, 2010).

voidable by the company.[71] This duty of disclosure is codified in Section 191 and Table A of the Cyprus Companies Law as explained above.

b) Secondly, directors are not allowed to make use of the company's property or any information or opportunity arising from holding office. The Cypriot courts may follow the English case law on corporate opportunities developed under common law and the Companies Act 1948. If directors gain profits due to their position in the company, they are considered to hold these profits as the company's trustees.[72]

c) The Directors are under a duty not to make any secret profits due to their position in the company. In cases where they do so they are considered to hold these profits as the company's trustees.[73] The case of *Regal (Hastings) Ltd v Gulliver*[74] is relevant in this context. In this case, the Court held that the directors who made a profit out of the company's transactions were accountable to the company for these profits. The Court however stated that the directors would have been protected if they had attained the company's consent in the general meeting of shareholders.

It is important to note that the Supreme Court of Cyprus has stated in *Giannakis Pelekanos and others v Andreas Pelekanos* that third parties, who knowingly participate in breaches of the duty of loyalty owed by directors to the company, are equally liable for the breach and are considered to be constructive trustees in relation to the company.[75]

3.1.2.2 Duty of skill and care

In addition to their fiduciary duties, directors owe a duty of care to the company in common law not to act negligently in managing the affairs of the company. The Cyprus Companies Law does not specify this duty, but Cypriot Courts have adopted the relevant English case law on the duty of care.[76]

The judgment of the Supreme Court in *Giannakis Pelekanos and others v Andreas Pelekanos* Civil Appeal No. 10953 (2006) 1A S.C.J. 390 is informative in this regard. As mentioned above, it was held that the defendant directors had acted in such a way as to exclude their fellow director from the decision-making process, promoting their own interests over the interests of the company, and using property and personnel of the company. This was held to constitute, in addition to a breach of the duty to act in good faith, a breach of the duty of care and skill.

Some examples of breaches of skill and care as given by the Cypriot legal literature are as follows:[77]

- Negligent advice or inaccurate statements especially in cases of takeover or merger;
- Inaccurate forecasts of the company's returns;
- Any action which is ultra vires even if it was not malicious;
- Excessive borrowing which is harmful to the company;

[71] Aberdeen Rly Co. v Blaikie Bros (1854) Macq 461 (House of Lords).
[72] Cook v Deeks (1916) 1 AC 554 (Privy Council).
[73] Cook v Deeks (1916) 1 AC 554 (Privy Council); *Giannakis Pelekanos and others v Andreas Pelekanos* Civil Appeal No. 10953 (2006) 1A S.C.J. 390
[74] Regal (Hastings) Ltd v Gulliver (1942) 1 All ER 378.
[75] *Giannakis Pelekanos and others v Andreas Pelekanos* Civil Appeal No. 10953 (2006) 1A S.C.J. 390
[76] *Re City Equitable Fire Assurance Co.* [1925] Ch 407. For Cyprus see "Personal Liability according to Common Law" in "The personal liability of company directors and officials and their insurance" Miltiades Miltiadous (Nicosia, 2010).
[77] "Personal Liability according to Common Law" in "The personal liability of company directors and officials and their insurance" Miltiades Miltiadous (Nicosia, 2010).

- Judgmental errors, such the continuation of the company's operations when the company should have been wound up; and
- Making unauthorised payments of salaries, compensations or dividends.

3.2 To whom are the duties owed?

Directors' duties are owed to the company as a whole and not to a distinct group of shareholders or creditors.[78] An exception to this general rule is the case of the company's insolvency. In the insolvency of the company the interests of the creditors are considered to be superior and the directors consequently owe a positive duty towards them to ensure that the company's affairs are handled properly.[79] Furthermore, in specific cases directors owe their duties to the shareholders directly.[80] An example is the case where the directors acquire the company's shares from a shareholder knowing that forthcoming events will cause the price of the shares to increase. In this case the directors are under a duty to inform the shareholder as they are in a position of trust towards the shareholder. Consequently, any profits gained belong to the shareholder.[81]

3.3 The director as a shareholder

There is no requirement in the Companies Law for directors to hold shares in the company. However, where the articles of association provide for such a requirement, every director appointed must acquire such shares within two months of the appointment; otherwise the office is deemed vacated (Section 176 of the Law).

If the directors own company shares, they have equal rights as any other shareholder. This is evident in the application of Section 191 of the Cyprus Companies Law. Where the director does not declare his personal interest in a contract or a proposed contract, the agreement concluded is considered voidable, but it may be accepted by the company in general meeting and the implicated director may exercise his voting rights as a shareholder.

3.4 Application of duties to *de facto* and shadow directors

The Cyprus Companies Law does not make any provision in relation to the specific duties of shadow or de facto directors. If a Cyprus Court is called upon to decide on the law as to directors' duties regarding a de facto or shadow director, it will rely on the jurisprudence of the English Courts in connection to the Companies Act 1948 and common law.

[78] "Chapter 8: Director's Duties" in "Company Directors" by Ch. Louka (1991) (Limassol).
[79] See also Section 311 of the Cyprus Companies Law, which protects the company's creditors from fraudulent trading.
[80] "Chapter 8: Director's Duties" in "Company Directors" by Ch. Louka (1991) (Limassol).
[81] Allen v Hyatt (1914) 30 T.L.R 444.

4 LIABILITY FOR BREACH OF DUTY

4.1 Duty of care: conditions for liability

As stated above, the Cyprus Companies Law does not specify what level of skill and care directors owe to the company. It has been established that if a director acts in good faith he or she cannot be held responsible to pay damages, unless guilty of grossly culpable negligence in a business sense. The Cypriot courts have not developed their interpretation of the duty of skill and care that a director owes to the firm but adopted the common law approach and followed its development in the case law.

In the judgment of the Supreme Court in *Giannakis Pelekanos and others v Andreas Pelekanos* Civil Appeal No. 10953 (2006) 1A S.C.J. 390, when discussing a breach of the duty of care and skill, the Court referred to the English judgement in *In Re City Equitable Fire Assurance Co.* [1925] Ch 407. It is noted that the Court did not conduct a detailed analysis of the judgment and simply upheld the abovementioned reference of the first instance District Court. In Cypriot law the standard of care applied to executive and non-executive directors is not different; both types of directors are treated the same under the Cyprus Companies Law which does not make any distinction between the two categories.

4.2 Exemptions and limitations

The Companies Law provides that any provision contained in the articles of association, memorandum or in any contract with a company exempting a director from, or indemnifying him against any liability, which he may otherwise have by virtue of any rule of law in respect of negligence, breach of duty or breach of trust been guilty in relation to the company, shall be void.[82] This does not mean that the director is deprived of any possibility of exemption or right to be indemnified in respect of anything done by him. The company may indemnify directors against the costs incurred in legal proceedings, whether civil or criminal, in which judgment is given in the director’s favour or the director is acquitted. It is noted that there is no provision in Cyprus Companies Law giving the power to shareholders to exempt a director from liability for breach of duty, having also in mind that the shareholders must act in accordance with the relevant provisions of the articles of association of the relevant company and of the Cyprus Companies Law.

In addition, the court may grant relief under section 383 of the Companies Law. Section 383 gives power to the court to relieve directors, wholly or partly, from liability if in any proceedings for negligence, default, breach of duty or breach of trust it appears to the court that the director has acted honestly and reasonably, and that having regards to all the circumstance of the case, including those connected with the director’s appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust. Pursuant to section 383(2), the director is able to apply to the court for relief if he apprehends that an action for breach of duty or breach of trust, negligence or default will be taken against him, and the court may grant him relief as if the case was before it. It is not enough for the director to have acted honestly and reasonably, but it must additionally be proved that he ought fairly to be excused. We are not aware of relevant case law applying s.383.

[82] Cyprus Companies Law, CAP 113, Section 197.

Finally, a director may take out insurance against personal liability and the company may pay the insurance premium; however, it is noted that this rarely occurs and it mainly relates to the banking sector.

4.3 Consequences of liability

According to Section 194(1) of the Companies Law, the directors' liability in a company may be unlimited if this is provided expressly for in the memorandum. This rarely occurs.

In order for this to be the case, under section 194(2), the directors and any managers of the company and the member who proposes a person for election or appointment to the office of director or manager, must add to that proposal a statement that the liability of the person holding that office will be unlimited, and before the person accepts the office or acts therein, notice in writing that his liability will be unlimited must be given to him by the following or one of the following persons: the promoters of the company, the directors of the company, any managers of the company and the secretary of the company. Liability refers to breaches of duties of the director.

4.4 Duration of liability

There is no provision under Cyprus law on the continuation of the duty of a director not to make use of corporate opportunities even after his resignation as director, or indeed for the continuation of any other director's duty after resignation.

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 The meaning of 'vicinity of insolvency'

In Cyprus the test for insolvency focuses on the company's inability to pay its debts. Section 212 of the Companies Law identifies the situations where a company will be considered unable to pay its debts. These are:

- If the company owes more than EUR 855 to a creditor, the creditor may claim the debt by sending a formal letter to the registered office of the company. The company then has 21 days in which to pay the sum. If the company does not do so, the creditor may apply to the court requesting it to issue a liquidation order against the company;
- If execution or other process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part;
- If it is proven to the court's satisfaction that the company is unable to pay its debts. In order for such a decision to be taken the court will take into account the present and possible future liability of the company.

Regarding the so-called 'vicinity of insolvency', the relevant provision of the Cyprus Companies Law is section 169F which provides (section 169F(1)) that in the event that losses of past financial years, or other reasons, leads to the reduction of the share capital of a public company by 50% or to a level which, as per the opinion of the directors, puts the accomplishment of the company's goal under dispute, the directors have to call not later than 28 days from when the reduction became known to them an extraordinary general meeting at a date not exceeding 56 days from the date when the decision for calling the meeting was made, in order to assess whether the company must be dissolved or any other measure must be taken.

Under section 169F(2), an omission of the directors of the company to act as above constitutes a tort and renders them responsible for damages. The said responsibility is personal, unlimited, joint and several.

5.2 Change of existing duties

The directors of a company have a duty to the company to act in the best interests of the company and its beneficiaries at all times. This invariably applies to the time when the company experiences financial difficulties. Where the company is in the vicinity of insolvency, Cyprus company law is concerned with the collection and distribution of proceeds to the creditors. This is illustrated by sections 301 and 303 of the Law, which are aimed at creditor protection.

Section 301 of the Law states that "any conveyance, mortgage, delivery of goods, payment, execution, or other act relating to property made or done by or against a company, within six months before the commencements of its winding up which, had it been made or done by or against an individual within six months before the presentation of a bankruptcy petition on which he is adjudged bankrupt, would be deemed in his bankruptcy a fraudulent preference, shall in the event of the company being wound up be deemed a fraudulent preference of its creditors and be invalid accordingly." The court will in this case look at the real intention, not the result, in order to determine whether there was a fraudulent preference.

Section 303 of the Law states that where a company is being wound up, a floating charge on the undertaking or property of the company created within 12 months of the commencement of the winding up shall, unless it is proved that the company was solvent immediately after the creation of the charge, be invalid, except to the extent of any cash paid to the company at the time of, or subsequently to the creation of, and in consideration for, the charge.

Accordingly, and on the basis of the above stated sections of the Law, certain duties are imposed on the directors of companies in cases where the company is in the vicinity of insolvency, all of which come in line with the common law principle that a director of an insolvent company must have regard to the company's creditors. The meaning of "creditor" has been analysed by the Supreme Court in *Loukos Manufacturers Ltd* (2000) 1B S.C.J. 891 at pg. 894, where a creditor was described as including any person to whom the company owes a determined sum. Further the said term includes any person to whom the entire or part of the debt of the company has been transferred, the executor of the estate of a deceased person, or a municipal authority concerning owed taxes. To that effect, the Supreme Court made, at the said pg. 894, direct reference to the judgments in *Re World Industrial Bank* [1909] W.N. 148, *Re Paris Skating Ring* [1877] 5 Ch.D. 962, *Re Steal Wing Co.* [1921] 1 Ch. 349, *Masonic & General Life Assurance* [1886] 32 Ch. D. 373, *In Re The North Bucks Furniture Depositories Limited* [1939] Ch. 690, *Re McGreavy* [1950] Ch. 269.

5.3 Newly arising duties

When a winding-up order is issued or a resolution of winding up is passed the directors' powers cease and the liquidator of the company takes over.[83] This was confirmed in Maria Lazarou v Antoni Koumettou,[84] where the court held that the powers of the directors and representatives of the company cease when a winding up order is made. Any disposition of the company's property by the company between the commencement of the winding up and the order for winding up is void, unless the court otherwise provides. The court further stated that the relevant provision of the law existed to prevent the officers of the company from dispersing the company's assets after the application for winding up was filed. Directors must submit to the liquidators a statement of affairs of the company and the liquidator will, in performing his duties, examine the director's conduct at the time when the company was carrying out business.

Generally, if directors act honestly for the benefit of the company that they represent, they discharge their legal duties and are not themselves liable, even in cases of negligent mismanagement.[85] In the

[83] Cyprus Companies Law, CAP 113, Sections 245 and 268.
[84] Maria Lazarou v Antoni Koumettou and others Civil Appeal No. 11352, 25 February 2003.
[85] Maria Kyriakou, "Chapter 7: Cyprus" in: Christopher Mallon, "The Restructuring Review" (2010) (Third Edition).

context of a derivative action (below) and at first instance, the District Court of Nicosia in its Interim Judgement in Action No. 711/2011 *Vitaly Ivanovich Smagin v Skendleby Investments Limited, Jella Holdings & Finance Limited, Andrey Ilyaev, Prechard Holdings Limited, Solid Rock Trading Limited, Executive Management Limited and MPH Law Management Limited*, citing Palmers' Company Law, Volume 2, (Issue 2000 loose leaf), stated that the derivative action and the right to bring it forward, due to its origin in the law of equity, is limited by various factors and finds no application against a company director who shows mere negligence in the performance of his duties or where the action of the directors or of the company could have been ratified by a general meeting resolution.

The exceptions to the immunity of directors are: breach of statutory obligations which can be enforced against the directors during the winding up of the company and the signing of documents without the company's authority or not in the company's name, but in their personal capacity.

The most important potential ground of directors' liability is fraudulent trading. Fraudulent trading is interpreted widely in an attempt to protect creditors and pierce the corporate veil. It is set out in section 311 of the Companies Law, which states that if, in the course of a winding up, it appears that any business of the company was carried on with the intention to defraud the company's creditors or for any fraudulent purpose, the court may declare that the directors who were knowingly parties to the fraud will be personally liable for all or any of the debts or liability of the company. It is important to note that the law covers past and present directors as well as *de facto* directors who were active participants in the management of the company during the period when fraudulent trading was taking place. Under the Law, fraudulent trading is considered a criminal offence as well as a civil offence, and directors may be liable to a fine not exceeding £1500 CY or 3 years imprisonment or both. Due to the high standard of proof required, successful claims for fraudulent trading are very rare.

In addition, section 312 of the Companies Law gives the court the power to assess damages against directors (and other responsible officers or liquidators) if in the course of the winding up of a company it appears that they have misapplied or retained or became liable for any money or property of the company or have been guilty of any misfeasance or breach of trust in relation to the company.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue

6.1.1 The company as plaintiff

Companies, being legal personas, act in accordance with decisions taken by the board of directors and by ordinary resolution in general meetings. Although the decisions are usually taken by democratic means, that is the decision of the majority is followed, there are times when some directors control most of the votes on either the board of directors or in the general meeting, which may result in the oppression of minority shareholders or the lack of enforcement of claims against the directors. In such cases, the company, as well as the shareholders, may act as plaintiffs in actions against the directors who act in an oppressive manner or behave to the company's detriment. The requirements under which the shareholders can bring a claim will be analysed below.

6.1.2 The shareholders as plaintiffs

6.1.2.1 In their own name

Shareholders may bring an action in their own name when their personal rights have been infringed. An example of such an infringement, which was examined by the Cypriot courts, is the wrongful and illegal prohibition of a shareholder to vote in a general meeting.[86]

In addition to the above, Section 202 of the Cyprus Companies Law allows shareholders to bring an action in their own name if they consider that the company's affairs are being conducted in an oppressive manner. Section 202 stipulates that "[a]ny member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members (including himself) . . . may cause an application to be made to the court by petition for an order under this section." The Supreme Court of Cyprus held in the case of *In re Pelmako Development Limited*,[87] at pg. 1375, that Section 202 constitutes, subject to certain minor wording differences, a copy of Article 210 of the English Companies Act 1948. The Court continued by stating that, on this premise, guidance can be sought from the related English case-law on this subject.

The conditions which must be satisfied in order for a shareholder to invoke Section 202 of the Law are the following:

- The company's affairs must be carried out in a manner oppressive to some part of the shareholders;
- A court would be justified in issuing an order winding up the company on the basis that it is just and equitable to do so;[88] and
- The winding-up of the company would be to the detriment of the minority of shareholders.

[86] Z & I Mediterranean Leisure Investments Limited and others v. Ioanna Iliade – Loizou Civil Appeal No. 159/2005 25/05/2007.
[87] In re Pelmako Development Ltd Civil Appeal 8966 10/09/1999.
[88] Cyprus Companies Law, CAP 113, Section 211 (ST) –Άρθρο 211 ΣΤ.

The Court, in cases where the above requirements are met, may with a view to “bringing to an end the matters complained of, make such order as it thinks fit, whether for regulating the conduct of the company’s affairs in future, or for the purchase of the shares of any members of the company or by the company and, in the case of a purchase of the said shares by the company, for the respective decrease of capital of the company or otherwise.”[89]

In the case of *In re Pelmako Development Limited*,[90] the court upheld the English judgment in *Re Five Minute Car Wash Service Ltd*,[91] in which the notion of oppression was interpreted. The court described the elements that a claim for minority oppression must contain. The claim must:

- Concern the rights of the company’s members;
- Be in relation to the management of the company’s affairs;
- Make the company’s dissolution just and equitable; and
- Show oppression to those members seeking the company’s dissolution.

As to the meaning of the term “oppression”, the Court followed the explanation of the term in the House of Lords case *Scottish Co-Operative Wholesale Society Ltd v Meyer*.[92] The term “oppression” has been interpreted to include the elements of lack of probity or fair dealing towards the members of the company in relation to their rights as shareholders. Inefficiency or negligence in the managements of the company’s affairs cannot constitute “oppressive behaviour”.

The term “just and equitable” has also been examined by the courts. In the case of *In re Pelmako Development Limited*,[93] the Cypriot court held that the term “equitable” required a standard of behaviour as could be expected from a person who exercised the rights provided for in the memorandum and articles of association, and who fulfilled his obligations *bona fide* in the best interest of the company.

Section 202 of the Companies Law further specifies the remedies that the court may provide for. The court may make an order in relation to:

- The future management of the company’s affairs;
- The purchase of any shareholders’ shares by other members of the company; and
- The purchase of any shareholders’ shares by the company and the relevant capital reduction.

6.1.2.2 In the name of the company (‘derivative action’)

Directors of companies owe their duties to the company. The company, therefore, is the proper plaintiff in an action against the directors where the directors breach their duties towards the company. In some cases, however, the directors who are in breach of their duties may be in control of the company. Thus, it may be difficult to take action against the wrongdoers. The common law principles applicable to derivative actions were established by the leading English case of *Foss v Harbottle*,[94]

[89] Cyprus Companies Law, CAP 113, Section 202(2).
[90] Civil Appeal 7883 (1991) S.C.J. 246.
[91] Re Five Minute Car Wash Service Ltd. (1966) 1 All ER 242.
[92] Scottish Co-Operative Wholesale Society Ltd v Meyer (1959) AC 324.
[93] In re Pelmako Development Ltd Civil Appeal 7883 (1991) S.C.J. 246.
[94] Foss v Harbottle (1843) 67 ER 189.

which the Cypriot courts have adopted and followed, as well as its exceptions.[95] The rule in *Foss v Harbottle* provides that the company is the proper plaintiff in litigation for wrongs done to the company. This rule, however, leaves the matter to the majority of the board of directors or the shareholders, who, as stated above, may in some cases act in their own interest and to the company's detriment, thus placing the minority shareholders in a disadvantaged position. Consequently, several exceptions to the rule in *Foss v Harbottle* have been recognised. These are:

- Acts which are ultra vires or illegal under statute;
- Acts which can only be pursued by means of a special resolution adopted by the general meeting (e.g., amendment of the memorandum);
- Acts which infringe a shareholder's personal rights (in this case, the shareholder has a personal right to take action on his own name);[96]and
- Acts of fraud against the minority by those controlling the company.

In the case of *Iacovos Chimonides v Investylia Public Co Ltd*,[97] the Court stated that it is a requirement in derivative actions for the company to be added as a nominal defendant, in addition to the substantive defendants, otherwise the action will be stayed and the Court will order for it to be struck off. The derivative action is brought by a shareholder on behalf of the company (to that effect see *Theodoros Pirillis and another v. Eleftherios Kouis* Civil Appeal No. 11387 (2004) 1A S.C.J. 136). It is also noted that the Supreme Court in *Aimilios Thoma and others v. Iakovos Eliades* Civil Appeal 11784 (2006) 1B S.C.J. 1263 clearly stated that there is no requirement for the Claimant to secure a power of attorney from the company prior to filing the action.

As far as the fourth exception to the rule in *Foss v Harbottle* is concerned, a derivative action is permissible under two conditions: an act of fraud must have been committed against the minority, and the wrongdoer must be in control of the company. The term "fraud" has been interpreted widely by the courts. In the case of *Alexander v Automatic Telephone Co*,[98] the company's directors benefitted by forcing the other shareholders of the company to pay up the issue price of new shares immediately, whereas this did not apply to the directors themselves. Although the shareholders invoked equal treatment rights and did not bring a derivative action, the court considered the case to be an exception to the rule in *Foss v Harbottle*. The court further held, applying a wide notion of the term "fraud", that the directors had acted fraudulently by breaching their duties towards the company.

In the case of *Pavlides v Jensen*,[99] the English court determined that when directors act negligently in the exercise of their rights and do not profit from this negligence, this cannot be considered as "acting in fraud".

In the context of a derivative action and at first instance, as already stated above, the District Court of Nicosia in its Interim Judgement in Action No. 711/2011 *Vitaly Ivanovich Smagin v Skendleby Investments Limited, Jella Holdings & Finance Limited, Andrey Ilyaev, Prechard Holdings Limited, Solid Rock Trading Limited, Executive Management Limited and MPH Law Management Limited*, citing Palmers' Company Law, Volume 2, (Issue 2000 loose leaf), stated that the derivative action and the right to bring it forward, due to its origin in the law of equity, is limited by various factors and finds no application against a company director who shows mere negligence in the performance of his

[95] Z & I Mediterranean Leisure Investments Limited and others v. Ioanna Iliade – Loizou Civil Appeal No. 159/2005 25/05/2007 and Theodoros Pirillis and another v. Eleftherios Kouis Civil Appeal No. 11387 (2004) 1A S.C.J. 136.
[96] Z & I Mediterranean Leisure Investments Limited and others v. Ioanna Iliade – Loizou Civil Appeal No. 159/2005 25/05/2007.
[97] Iacovos Chimonides v Investylia Public Co Ltd (2008) 1B 1117.
[98] Alexander v Automatic Telephone Co. (1900) 2 Ch. 56.
[99] Pavlides v Jansen (1956) Ch. 565.

duties or where the action of the directors or of the company could have been ratified by a general meeting resolution.

In the case of *Daniels v Daniels*,[100] the English court stated that in cases where there is no other remedy a minority shareholder can bring an action against the directors of the company when they use their powers either deliberately or unwittingly, fraudulently or negligently in a way which benefits them to the company's detriment. This was also the outcome in the Cypriot Supreme Court case of *Aimilios Thoma and others v. Iakovos Eliades* Civil Appeal 11784 (2006) 1B S.C.J. 1263,[101] in which the Court considered that the conduct of the directors of the company constituted fraud as they attempted directly and indirectly to retain from the company, in which they were shareholders, money, property benefits and rights which belonged to the company and to which the other shareholders also had rights.

Under the fourth exception to the rule in *Foss v Harbottle*, the element of wrongdoer control is also important. Wrongdoer control may be the result of the possession of the majority of shares, control of the majority on the board of directors, or by having control over shares which carry a majority of voting rights. In the case of *Pavlides v Jensen*[102] mentioned above, the English court was willing to base control on the possession of nominal value shares, whereas in the case of *Theodoros Pirillis and another v. Eleftherios Kouis* Civil Appeal No. 11387 (2004) 1A S.C.J. 136,[103] the Supreme Court of Cyprus stated that the element of control should be determined by examining whether the company can act by itself in protecting its interests.

Another issue which must be flagged up is that the Cyprus Supreme Court has upheld in the cases of *Theodoros Pirillis and another v. Eleftherios Kouis* Civil Appeal No. 11387 (2004) 1A S.C.J. 136 and *Aimilios Thoma and others v. Iakovos Eliades* Civil Appeal 11784 (2006) 1B S.C.J. 1263, the judgements of the respective first instance District Courts as to the award of punitive damages due to the fraudulent behaviour of the wrongdoers.

Lastly, it is noted that the award of the costs lies in the discretion of the court.

6.2 Criminal and administrative sanctions

6.2.1 General

It is possible that directors of companies may be held criminally liable for offences they have committed during the time they hold office. In the case of listed companies the criminal liability of directors may arise under the Cypriot Securities and Stock Exchange Law. Section 189 of the Cyprus Securities and Stock Exchange Law states that "[a]nyone who, in the course of providing information for any of the purposes of this Law or the Stock Exchange Regulations, makes a statement which is false, misleading or fraudulent with respect to a material element of it or conceals anything material commits an offense which is punishable by imprisonment of up to two years or by a fine of up to five

[100] Daniel v Daniels (1978) 2 All E.R 89.
[101] Aimilios Thoma and others v. Iakovos Eliades Civil Appeal 11784 (2006) 1B S.C.J. 1263.
[102] Pavlides v Jansen (1956) Ch. 565.
[103] Theodoros Pirillis and another v. Eleftherios Kouis Civil Appeal No. 11387 (2004) 1A S.C.J. 136.

thousand pounds or by both penalties".[104] It is also important to note that under Cypriot law it is possible for both the company and the director or individual offender to be convicted. Under Article 190(1) of the Cyprus Securities and Stock Exchange Law, "[c]riminal liability for the offences provided in the Cyprus Securities and Stock Exchange Law committed by a legal person attaches to the legal person itself, as well as to any of the members of the Board of Directors, the General Manager, the Secretary or other office holder or organ of administration of the legal person proven to have consented or collaborated in committing the offence connected with a statement contained in the listing prospectus. Criminal liability also lies on the auditor, the underwriter of the issue, the investment advisor or any other person who has consented in the issuing of the listing prospectus."[105] Article 190 (2) of the same law states: "Persons who, according to the provisions of the preceding subsection, incur criminal liability for offences committed by a legal person are jointly and severally liable with the legal person for any damage caused to third parties as a result of their action or omission which constitutes the offence."[106] It is important to note that criminal prosecutions for offences committed in relation to the Cyprus Stock Exchange Laws and Regulations N.14(I)/1993 may only be instigated by the Attorney General of Cyprus or with his consent.[107]

In addition, Article 311 of the Cyprus Criminal Code states: "Any person who a) being a director or officer of a corporation or company, receives or possesses himself as such of any of the property of the corporation or company otherwise than in payment of a just debt or demand, and with intent to defraud, omits either to make a full and true entry thereof in the books and accounts of the corporation or company, or to cause or direct such an entry to be made therein, or b) being a director, officer or member of a corporation or company, does any of the following acts with intent to defraud, that is: i) Destroys, alters, mutilates or falsifies any book, document, valuable security or account which belongs to the corporation or company or any entry in any such book, document or account or is privy to any such act; or ii) makes or is privy to making any false entry in any such book, document or account, or, iii) omits or is privy to omitting any material particular from any such book, document or account is guilty of a felony and is liable to imprisonment of 7 years."[108] The same liability arises in cases where the director of a company "either existing or to be formed, makes, circulates or publishes, or concurs in making, circulating or publishing any written statement or account which, in any material particular, is to his knowledge false, with intent thereby to affect any of the purposes following: a) to deceive or to defraud any member, shareholder or creditor of the corporation or company, whether a particular person o not, b) to induce any person, whether a particular person or not to become a member of or to entrust or advance any property to the corporation or company or to enter into any security for the benefit thereof, is guilty of a felony, and is liable to imprisonment for seven years."[109]

6.2.2 Criminal Offences of Directors in insolvency proceedings

The Cyprus Companies Law determines a number of criminal offences that directors of companies may commit in the course of or before the winding-up of the company. These are: the director is bankrupt,[110] the director fails to keep proper accounts throughout the period of two years immediately preceding the commencement of the winding up,[111] the director fails to disclose and deliver property and books to the liquidator, conceals, falsifies or destroys any books or documents,[112] and the director

[104] Cyprus Stock Exchange Laws and Regulations N 14(I)/1993 (as amended), Article 189.
[105] Cyprus Stock Exchange Laws and Regulations N 14(I)/1993 (as amended), Article 190(1).
[106] Cyprus Stock Exchange Laws and Regulations N 14(I)/1993 (as amended), Article 190(2).
[107] Cyprus Stock Exchange Laws and Regulations N 14(I)/1993 (as amended), Article 190A.
[108] Cyprus Criminal Code, CAP 154, Section 311.
[109] Cyprus Criminal Code, CAP 154, Section 312.
[110] Cyprus Companies Law, CAP 113, Section 179.
[111] Cyprus Companies Law, CAP 113, Section 310.
[112] Cyprus Companies Law, CAP 113, Section 308.

fraudulently alters any documents, and attempts to account for any part of the property of the company by expenses or fictitious losses.[113] In all of the cases mentioned above, the directors shall be liable for imprisonment not exceeding two years if found guilty, except in the case where the director is bankrupt, in which case the director shall be liable for imprisonment not exceeding two years or a fine not exceeding EUR 170 or both.[114]

Further to the above, Section 313 of the Cyprus Companies Law determines that if it appears to the Court that "any past or present officer, or any member of the company has been guilty of any offence in relation to the company for which he is criminally liable, the Court may on the application of any person interested in the winding-up or on its own motion, direct the liquidator to refer the matter to the Attorney General".[115] Similarly, "if it appears to the liquidator in the course of a voluntary winding-up that any past or present officer or any member of the company has been guilty of any offence in relation to the company for which he is criminally liable, he shall report the matter to the Attorney General and shall furnish to the Attorney-General such information and give to him such access to and facilities for inspecting and taking copies of any documents, being information or documents in the possession or under the control of the liquidator and relating to the matter in question, as he respectively may require."[116] In such cases, the Attorney General may, if he considers that this is a case in which a prosecution ought to be constituted, institute proceedings.[117]

In practice, such criminal sanctions are rarely put into play, whilst the discretion lies in the hands of the Attorney General, who, as per Article 113.2 of the Constitution of the Republic of Cyprus, has the power, exercisable at his discretion in the public interest, to institute, conduct, take over and continue or discontinue any proceedings for an offence against any person in the Republic.

[113] Cyprus Companies Law, CAP 113, Section 309.
[114] Cyprus Companies Law, CAP 113, Section 179.
[115] Cyprus Companies Law, CAP 113, Section 313(1).
[116] Cyprus Companies Law, CAP 113, Section 313(2).
[117] Cyprus Companies Law, CAP 113, Section 313(5).

7 CONFLICT OF LAWS

7.1 Company law

Cyprus has adopted the incorporation theory for purposes of private international company law. It uses the place of establishment of the company as the deciding factor in identifying the law applicable to the company. This is illustrated by the definition of the term "company" in section 2(1) of the Cyprus Companies Law, which states that "company means a company formed and registered under this Law". This means that the provisions of the Cyprus Companies Law only apply to companies incorporated in Cyprus, whilst foreign companies are regarded as being governed by the laws of the countries where they are incorporated, regardless of where the company's operations are based. The Cyprus Companies Law does, however, include provisions applicable to overseas companies (sections 347-362) that concern the establishment of a place of business in Cyprus, disclosure requirements, the winding-up of companies, re-domiciliation of companies to and from Cyprus (under section 354A and thereafter), and the Societas Europeas. In relation to the latter, secondary legislation is in force, namely the SE Regulations of 2006.

As a consequence of the application of the incorporation theory, the duties and responsibilities of directors as codified in the Cyprus Companies Law or derived from case law, apply to companies formed or registered under Cypriot law, but not to directors of foreign incorporated companies.

7.2 Tort law

A director may face a claim, amongst others, under the heading of the law of negligence and pursuant to tortuous offences created by the Cyprus Companies Law, such as under section 169F(2) thereof.

It must also be noted that although Regulation (EC) No. 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II) is generally applicable in the Republic of Cyprus, in accordance with Article 1A of the Constitution of the Republic of Cyprus, Article 2(d) of the said Regulation excludes from its scope of application, inter alia, non-contractual obligations arising out of the law of companies and other bodies corporate or unincorporated regarding matters such as the personal liability of officers as such for the obligations of the company.

7.3 Special duties in the vicinity of insolvency

It has been stated that "Cyprus' substantive law on insolvency is parallel to private international law and thus it could be classified pursuant to private international insolvency law."[118]

[118] Maria Kyriakou, "Chapter 7: Cyprus" in: Christopher Mallon "The Restructuring Review" (2010) (Third Edition).

Section 362 of the Cyprus Companies Law states that "a company which has been formed outside Cyprus and which carries on business within Cyprus may be wound up under the provisions of the Cyprus Companies Law, notwithstanding that it was dissolved pursuant to the laws of the country under which it was incorporated".[119] Thus, in cases of insolvency of foreign companies, Cyprus law also applies to the directors of overseas companies which operate in Cyprus, regardless of whether these companies were wound up in the country of their registration.

The accession of Cyprus to the European Union has meant the supremacy of EU Law (primary and secondary) over national laws. This is also the effect of Article 1A of the Constitution of the Republic of Cyprus. Regulation 1346/2000 on cross-border insolvency proceedings consequently is directly effective in Cyprus.[120]

In relation to insolvency proceedings of companies outside the European Union, "a number of attempts on cross-border insolvency procedures have established that a foreign judgment cannot affect the insolvency provisions of another state".[121] The Judgments of Foreign Courts (Recognition, Registration and Execution by Treaty) Law, L. 121 (1)/2000, states that a foreign judgment may be recognised and enforced in Cyprus if a bilateral treaty between Cyprus and the country in which the judgment was delivered exists or in cases where Cyprus has to apply multilateral conventions which it has signed and is bound by.[122] In cases where a judgment by a foreign court has to be enforced in Cyprus, a specific procedure needs to be adopted and thus national courts do not automatically give effect to foreign judgments.[123] This is specified in Section 4 of the Judgments of Foreign Courts (Recognition, Registration and Execution by Treaty) Law, L. 121 (1)/2000, which states that an application for registration of a foreign judgment has to be made ex parte, and it should be accompanied by an affidavit in support. A certified copy of the judgment and a duly certified copy of the Greek translation should be presented to the district court of the debtor's residence where the judgment may be registered or to the district court of the area where the property to which the judgment relates is located.

In addition, Cyprus has signed the Hague Convention on the Recognition and Enforcement of Foreign Judgments in Civil and Commercial matters, which establishes common provisions on mutual recognition and enforcement of judicial decisions in the signatory countries. According to Article 4 of the Convention, "a decision rendered in one of the Contracting States shall be entitled to recognition and enforcement in another Contracting State under the terms of this Convention:

1) If the decision was given by a Court considered to have jurisdiction within the meaning of this convention, and
2) If it is no longer subject to ordinary forms of review in the State of origin."[124]

In addition to the above requirements, it is essential that the decision is enforceable in its country of origin.

[119] Cyprus Companies Law, CAP 113, Section 362.
[120] Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings.
[121] Maria Kyriakou, "Chapter 7: Cyprus" in: Christopher Mallon "The Restructuring Review" (2010) (Third Edition).
[122] Maria Kyriakou, "Chapter 7: Cyprus" in: Christopher Mallon "The Restructuring Review" (2010) (Third Edition).
[123] Maria Kyriakou, "Chapter 7: Cyprus" in: Christopher Mallon "The Restructuring Review" (2010) (Third Edition).
[124] Convention on the recognition and enforcement of foreign judgments in civil and commercial matters and supplementary protocol, Article 4.

Directors' Duties and Liability in the Czech Republic

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CONTENTS

1 INTRODUCTION

The law of the Czech Republic belongs to the civil law family. One of the features of civil law is the dual conception of private and public law. The private law is traditionally defined as the law which serves the interests of an individual and public law as the law which serves the interests of public[1]. The areas of private law are civil law, which includes the law of obligations (or contract law as it is called in common law), law of torts, property law and family law, commercial law; corporations law and labour law.

The development of private law in the territory of the Czech Republic was strongly influenced by Austrian and German law. After the fall of the Holy Roman Empire, the Kingdom of Bohemia (Czech Republic) became part of the Austrian Empire. The first codification of private law was contained in the Common Civil Code (Allgemeines bürgerliches Gesetzbuch or ABGB) from 1811. The ABGB served as an inspiration for the new Civil Code which will be dealt with later. The first codification of commercial law (including the corporation law) in the Czech lands was contained in the Common Commercial Code from 1863. Both ABGB and the Common Commercial Code were in force until 1950.

The development of the private law was interrupted by the political changes after the Second World War when Czechoslovakia became a communist state and the law was recodified according to the Soviet model.

After the 1989 Velvet Revolution the communist regime collapsed and the reconstruction of private law was started. Today the main source of commercial and corporate law is Act No. 513/1991 Coll., Commercial Code (hereinafter the Commercial Code), where the regulation of companies is contained and directors' duties are codified.

The Commercial Code

The Commercial Code, in Czech "Obchodní zákoník", came into effect from 1 January 1992. It repealed a number of previous acts, such as the Economic Code[2], Joint Venture Act, Joint Stock Companies Act, Act on Economic Planning and others.

The Commercial Code was amended several times between 1992 and 2000. The most extensive amendments were adopted under Act No. 370/2000 Coll., effective from 1 January 2001, as part of the process of harmonising Czech law with European Union legislation.

The regulation of company transformations was moved from the Commercial Code into Act No. 125/2008 Coll., on transformations of commercial companies and cooperatives[3]. This act incorporates the relevant provisions of European Union law[4].

[1] Ulpianus: Ius civile est quod ad singulorum utilitatem spectat, ius publicum est quad ad statum rei Romanae spectat.
[2] Act No. 109/1964 Coll. "Hospodářský zákoník."
[3] Zákon č. 125/2008 Sb., o přeměnách obchodních společností a družstev.

Scope of the Commercial Code

The Commercial Code[5] contains fundamental provisions on entrepreneurs, on the formation and structure of companies, partnerships and co-operatives and detailed provisions on various types of contracts, which are not governed by the Civil Code[6].

According to § 1 (1) "this Code regulates the status of entrepreneurs[7], business obligations and some other relations connected with business activities[8]". An example of other relations connected with business activities would be the provisions on unfair competition contained in the Commercial Code.

The Commercial Code is lex specialis to the Civil Code. Civil law is the general basis for commercial law. Commercial law is a set of special rules stating differences from the general provisions of civil law. The hierarchy of sources of commercial law is described in § 1 (2) of the Commercial Code: "The legal relations specified in subsection (1) above are subject to the provisions of this Code. Should it prove impossible to resolve certain issues according to the provisions of this Code, they shall be resolved in accordance with the civil law provisions. In the event that such issues cannot be resolved in accordance with the civil law provisions, they shall be decided according to commercial practice and, in its absence, according to the principles upon which this Code is based".

Corporate Landscape

Part two of the Commercial Code regulates both how companies are formed and also how they are to be run. General provisions for all companies are set in § 56 – 75b. The Commercial Code then contains specific provisions for four different company types:

- Partnership (Veřejná obchodní společnost, "v.o.s.") § 76 – 92

A partnership is a company in which at least two persons carry on business activity under a common commercial name and bear joint and several liability for the obligations (debts) of the partnership with all their property.

- Limited partnership (Komanditní společnost, "k.s.") § 93 – 104

A limited partnership is a company in which one or more partners are liable for the partnership's obligations up to the amount of his unpaid contribution ("limited partner"; in Czech "komanditista"), and one or more partners are liable for the partnership's debts with their entire property ("general partner"; in Czech "komplementář").

[4] Third Council Directive *78/855/EEC* concerning mergers of public limited liability companies, Sixth Council Directive *82/891/EEC* concerning the division of public limited liability companies and the Directive *2005/56/EC* on cross-border mergers of limited liability companies.

[5] The Czech Commercial Code can be compared, to some extent, with the Companies Act and the Sale of Goods Act in the UK and the Uniform Commercial Code in the USA.

[6] Act No. 40/1964 Coll., Civil Code (zákon č. 40/1964 Sb., občanský zákoník).

[7] The Czech word "podnikatel" is also translated as "businessman" or "businessperson" and refers to both legal entities and individuals conducting business activity in accordance with § 2 (2).

[8] The term "business activity" is sometimes also referred to as "entrepreneurial activity"; in Czech "podnikání".

- Limited liability company (Společnost s ručením omezeným, "s.r.o.") § 105 – 153

A limited liability company is a company whose registered capital is made up of its members' contributions and whose members are not liable for the company's obligations[9] and it is a very popular legal form for small- and medium-sized businesses in the Czech Republic.

A limited liability company can be formed by one or more persons (individuals, companies), but the maximum number of its members is 50. The registered capital of a limited liability company must be not less than CZK 200,000.

- Joint-stock company (Akciová společnost, "a.s.") § 154 – 220

A joint-stock company is a company whose registered capital is divided into a certain number of shares with a specific nominal value. The company is liable for its debts with its entire property. A shareholder is not liable for the company's obligations. The legal form of a joint-stock company was the legal form into which former state-owned enterprises were transformed during privatisation in the 1990s.

According to § 162 (1) joint-stock company can be founded by a single person if such person is a legal entity; otherwise by two or more persons. The subsequent concentration of shares in the hands of one individual (natural person) shall not cause the nullity of such company or be the ground for winding-up.

The registered capital of a limited liability company being formed with a public offer of shares must be at least CZK 20 million, unless other statutory provisions stipulate a higher amount. The registered capital of a public limited company formed without a public offer of shares must be at least CZK 2 million.

Specific rules

Aside from these key provisions of the Commercial Code, the sector or activity of the company can make it subject to other specific rules.

Joint-stock companies with listed shares are subject to the Capital Market Act[10]. This Act regulates the provision of services on the capital market, capital market protection and the protection of investors, and the public offering of securities. Companies whose business is the collective investment carried on under the permission issued by the Securities Commission ("Komise pro cenné papíry") are subject to the Act on Investment Companies and Investment Funds[11].

Supervision over the entire financial market (banking, capital market, insurance) is performed by the Czech National Bank[12]. The supervisory powers of the Czech National Bank are contained in the Act

[9] After a complete payment of contribution was recorded in the Commercial Register.
[10] Act No. 256/2004 Coll., on business activities on capital market (zákon č. 256/2004 Sb., o podnikání na kapitálovém trhu).

[11] Act No. 248/1992 Coll., on investment comapies and investment funds (zákon č. 248/1992 Sb., o investičních společnostech a investičních fondech).

[12] From 1 April 2006 when a merging occurred of banking oversight, performed until this time by the Czech National Bank, with supervision over the capital market of the Securities Commission, supervision of the insurance and supplementary pension insurance industries performed by the Ministry of Finance and the Office for Supervision of Credit Unions.

No. 15/1998 Coll. on Supervision in the Capital Market Area[13] and in the Act No. 189/2004 Coll., on Collective Investment[14].

Banks are subject to the Act on Banks[15] and insurance companies to the Act on Insurance[16]. Another example of specific regulation in the Czech Republic can be the state-owned company. Status and legal relations of the state-owned company are governed by the Act on State Owned Company[17].

The Corporate Governance Code based on the OECD Principles was issued by the Czech Securities Commission in 2004 and is intended predominantly for companies whose securities are listed on the regulated market. The Securities Commission recommends that companies with listed securities include in their annual reports a declaration concerning the degree of accord of their corporate governance systems with the recommendations of the Code. The Code itself is not binding; it is only a statement of best practice.

Capital Market

The size of the capital market in the Czech Republic can be described as small. As of 17 February 2012 the number of listed companies on the Prague Stock Exchange ("Burza cenných papírů Praha") was twenty-six[18]. Of these companies only fifteen are joint-stock companies formed and governed by the Czech Commercial Code. The rest are foreign companies incorporated in Austria (Vienna Insurance Group or Erste Group Bank), Luxembourg (ECM, ORCO), Netherlands (Fortuna) or elsewhere.

Recodification

The Czech Republic is in the phase of recodification of private law. The new Civil Code, inspired by ABGB and prepared by Professor Karel Eliáš, was approved by the Senate on 25 January 2012, signed by the president on 20 February 2012 and will be effective from 1 January 2014. The new Civil Code was already entered into the Collection of Acts under number 89/2012. The new Act on Business Corporations[19], which will replace the Commercial Code and the new Act on Private International Law will come into force together with the new Civil Code.

(Act No. 57/2006 Coll. on Amending Laws in Connection with the Unification of Financial Supervision (zákon č. 57/2006 Sb., o změně zákonů v souvislosti se sjednocením dohledu nad finančním trhem).

[13] Zákon č. 15/1998 Sb., o dohledu v oblasti kapitálového trhu.

[14] Zákon č. 189/2004 Sb., o kolektivním investování .

[15] Act No. 21/1992 Coll., on banks (zákon č. 21/1992Sb., o bankách).

[16] Act No. 277/2009 Coll., on insurance (zákon č. 277/2009 Sb., o pojišťovnictví).

[17] Act No. 77/1997 Coll., on state owned company (zákon č. 77/1997 Sb., o státním podniku).

[18] The list of all the companies listed can be viewed at http://www.bcpp.cz/Cenne-Papiry/Default.aspx (17.2.2012).

[19] Act No. 90/2012 Coll.

2 CONCEPT OF COMPANY DIRECTOR

The Czech Commercial Code requires a two-tier corporate governance system for joint-stock companies. Corporate powers are divided between a board of directors ("Představenstvo") and a supervisory board ("Dozorčí rada"). Both a board of directors and a supervisory board are called "statutory organs" of the company.

The legal status of members of statutory organs is codified in § 194 of the Commercial Code. The rule explicitly applies to members of the board of directors and by reference also to members of the supervisory board (§ 200 (3)).

J. Pokorná describes the basic element of this regulation, which is "*the subordination of executive and supervisory bodies to the general meeting of shareholders, because the general meeting constitutes these organs and these organs must also follow the principles and instructions approved by the shareholders.*"[20]

Shareholders' directions

General meeting of shareholders ("Valná hromada") is according to § 184 (1) the supreme organ of a joint-stock company. It is explicitly stated in § 194 (4) that "the board of directors shall follow the principles and instructions approved by the general meeting, provided that they conform to the statutory provisions and the articles." The ASPI Commentary on this section explains that a member of the board of directors must decide independently and although difficult in practice, a member must not fulfill orders of the shareholder who proposed him into the office; only follow the instruction of the general meeting. Section 194 (4) then goes on to state that "unless this Code provides otherwise, no person is authorized to give instructions to members of the board of directors concerning management of the company's business." The ASPI Commentary explains that the board of directors has the exclusive status in terms of business management; no one can give instructions in this area.

Board of Directors

Every limited liability company must have the board of directors, which is "a collective statutory organ deciding all company matters not within the competence of the general meeting or supervisory board". According to § 194 (1) members of the board of directors are elected and recalled by a simple majority of the shareholders attending the general meeting. The articles may determine that members of the board of directors shall be elected and recalled by the supervisory board in a manner stipulated therein. The tenure of members of the board of directors should be given in the articles, but can not exceed five years.

It is required by § 194 (3) that the board of directors of joint-stock company has "no fewer than three members," but the exception to this rule is the company with one shareholder. It goes on to provide

[20] Pokorná, J.: *Ochrana nepodnikatele a členové orgánů obchodních společností*, Právní fórum, 2009/3, p. 112.

that "the members of the board shall elect a chairman. The board of directors shall take decision by a majority vote of its members, with the majority being specified in the articles, or else by a simple majority of all the members. Each member shall have one vote."

De jure director

The Czech Commercial Code does not contain any definition of a director. Requirements to become a member of the board of directors are set out in § 194 (7). According to this section a member of the board of directors can only be an individual (a natural person), "who has attained the age of 18, has a full legal capacity, has the integrity within the meaning of the Trade Act[21] and there is no impediment to carry on a trade within the meaning of the Trade Act.[22]"

An individual who does not meet these requirements or on whose side there is an impediment to become a director shall not become a director, even if properly appointed. If a member of the board of directors ceases to meet the requirements stipulated by this Code or other statutory provisions, his function is terminated. This shall not affect the rights of third parties acquired in good faith.

Disqualification

According to § 38l (1) of the Commercial Code the statutory organ or its member "cannot be a person who performed similar function in a company that became insolvent". The purpose of this provision is to prevent an individual who could harm the company from becoming a director.

Obstacles to performing the function are not expressed entirely precisely. According to § 381 (2), "*an obstacle exists against a person who performed the function of a member of a statutory organ in a legal entity at least one year prior to submitting an insolvency proposal.*"

Subsection 3 sets the length of the obstacle to become a company director. A person is disqualified from becoming a director for a period of three years from the date of "*legal force of the resolution on annulment of the bankruptcy as a result of the compliance with the resolution to distribute the assets or the resolution, by which the bankruptcy was annulled due to insufficient property of the debtor or the resolution on refusal of the insolvency proposal due to insufficient property.*"

The general meeting as the supreme organ of the company can still elect such a person a director with two thirds majority of the votes of the shareholders present on the condition they all knew about the obstacle (§ 38l (5)). The same majority is required for confirmation of election of the director when the obstacle arose during her function. If the confirmation is not given within three months then according to § 38l (6) "the director's function is terminated on the last day of that period".

[21] According to § 6 (1) of the Act No. 455/1991 Coll., on trade (zákon č. 455/1991 Sb., o živnostenském podnikání), a person who has been convicted for an intentional criminal offence committed in trade has no integrity.

[22] The Trade Act lists impediments to carrying on a trade in its § 8. Trade can not be carried on by a natural or legal person who has been declared bankrupt or insolvent.

De facto director

In the Czech Republic, the Commercial Code provides for the personal liability of members, both of the board of directors and the supervisory board, for their actions. According to the authors of the Corporate Governance Code, the situation that prevails in many companies is that the supervisory board meets only once or twice each year and the board of directors meets the same number of times. The board of directors delegates the direction of the company to a general manager, who appoints his own management board. In the past the general manager was only an employee and as such was not accountable to the shareholders. His liability was limited under the Labour Code to four and one half times his salary.

This loophole was closed when the Commercial Code amendment introduced through § 66 (6) a special liability of true leading persons. According to § 66 (6) "the provisions of this Code and specific statutory provisions on liability and suretyship of corporate organs and members of such organs shall also apply to persons who, as a result of a contract (agreement), their share in a company or other factors, have substantial influence over the company's conduct, even though they are not company organs or members of such organs, irrespective of their relationship to the company."

Thus, any person, who has a substantial influence on the activities of the company, for example the general manager or the parent company, is accountable to the same extent as the members of the board of directors, i.e. without any limitation.

Supervisory Board

The supervisory board of a joint-stock company is primarily a supervisory body. A member of the supervisory board may not concurrently be a member of the board of directors. The scope of the supervisory board's powers is stipulated in the Commercial Code. In § 197 (1) it is said that the supervisory board "shall monitor how the board of directors exercises its powers" and in doing so the members of the supervisory board are "entitled to examine all documents and records relating to the company's activities and to check whether bookkeeping entries are made in accordance with the actual facts and that the business activities of the company conform to the statutory provisions, the articles and the instructions of the general meeting".

The supervisory board shall consist of no fewer than three members; the number of its members must be divisible by three without remainder. Members of the supervisory board can be elected for a period of up to five years, unless it is the first supervisory board after the company's incorporation, in which case tenure is for one year only.

According to § 200 (3) the provisions § 194 (2), (4) to (7) and § 196 shall apply to members of the supervisory board as appropriate. Members of the supervisory board must therefore "follow the principles and instructions approved by the general meeting", have same duties as the members of the board of directors and are liable to the same extent. There are the same requirements for an individual to become a member of the supervisory board as they are for the member of the board of directors.

Employee participation

The competitiveness and ultimate success of a company is the result of teamwork that embodies contributions from a range of different parties. Companies considerably profit from the fact that their employees are willing to invest their abilities and knowledge in the company and it is therefore in their interest to involve them in corporate governance.

According to § 200 (1) “two-thirds of members shall be elected by the general meeting, and one-third by the employees of the company, provided that the company employs more than 50 people in an employment relationship”. Two-thirds of the supervisory board’s members are elected by the general meeting and one-third by employees of the company, if it employs at least 50 people.

The articles can increase the number of supervisory board members elected by employees up to one-half of the board’s members. The articles can also provide that, even if there are fewer than 50 employees, they can elect a member (members) of the supervisory board. The statutory provisions on employees’ representatives and works councils are included in the Labour Code.

3 SCOPE OF DIRECTORS' DUTIES

As we have seen, the Czech law takes a shareholdercentered view of the company. Companies are managed by directors for the benefit of shareholders. The Commercial Code codifies the general duties of directors. In the leading commercial law textbook[23], I. Pelikánová classifies directors' duties into four groups in order of importance:

- Duty to exercise powers with due managerial care § 194 (5) first sentence
  ("Povinnost vykonávat působnost s péčí řádného hospodáře a zachovávat mlčenlivost")
- Duty to follow the principles and instructions of the general meeting § 194 (4)
  ("Povinnost řídit se zásadami a pokyny valné hromady")
- Prohibition of competitive conduct § 196
  ("Zákaz konkurence")
- Protection in case of conflict of interests § 196a
  ("Ochrana před konfliktem zájmů")

1. Duty to exercise powers with due managerial care

Members of the board of directors shall according to § 194 (5) first sentence "exercise their powers with due managerial care ("s péčí řádného hospodáře") and not disclose confidential information and facts to third parties, if such disclosure might be detrimental to the company." Exercise powers with due managerial care - this is all the Czech Commercial Code, and indeed the Czech law, has to say about the most important duty of directors. No explanation, no further description, only this short and wide worded requirement that directors exercise their powers with due managerial care and confidentiality. I have consulted the leading authors on commercial law in the Czech Republic to find out more about the meaning and scope of the concept of due managerial care.

I. Štenglová states that under the term due managerial care one can imagine "*the care with which the landlord, equipped with the necessary knowledge and skills and who acts responsibly and thoroughly, takes care of his own property.*" She then continues "*it cannot be required that the board member was an expert in all areas. The care is the ability to identify activities which a member of the board is unable to perform, in which case a qualified person should be hired.*"[24]

The Supreme Court confirmed this opinion, when it stated that "...*the member of the board of directors of a joint-stock company does* [not have to] *to possess all possible technical knowledge relating to the function, but fundamental knowledge enabling him to distinguish impending damage and prevent its affect on the managed property.*" The court then continues and says that "*due managerial care also includes the duty of the member of the board of directors to recognize when technical assistance is necessary from a qualified entity and to ascertain such assistance.*"[25]

[23] Pelikánová, I.: Obchodní právo, 1. díl, CODEX, 1998, p. 447-453.
[24] Štenglová, I. in Štenglová, I.; Pliva, S.: Tomsa, M.: Obchodní zákoník, komentář, 11th ed., Praha: C. H. Beck, 2006, p. 745.
[25] Decision of the Supreme Court of the CR, docket number 5 Tdo 1224/2006.

S. Černá is of the opinion that the proper performance of due managerial care "requires such a level and quality of care for the affairs of the company as made by a diligent and properly acting landlord." The specific content of the duty, which is the matter of interpretation, "should involve diligence and prudence in carrying out the function and professional management of the company."[26].

Two decisions of the Supreme Court detail this aspect of due managerial care. The term due managerial care can be understood as the fact that "*a manager performs legal acts concerning the company responsibly and conscientiously and cares for its property the same as if it was his own. Such care undoubtedly includes prevention of damage by loss or degradation, but also that company property would be increased in value and expanded in the maximum possible way that is momentarily attainable*.[27]" This is confirmed in another decision, which states that "*members of the board of directors breach the duty of due managerial care if they do not attain such profit for the company that was realistic.*"[28]

A very detailed outlook on due managerial care brings R. Čech. Personal characteristics of a director should be both the traditional values of care, prudence and thrift, but R. Čech also highlights the need for courage and creativity. A perfect blend of characteristics is, in the opinion of this author, "somewhere between caring and courageous manager, whose innovative ideas can change the world." The position of director is according to this author "associated with lower risk aversion, which could be dangerous for the company, but at the same time risk-taking is necessary for the development of the company."[29]

According to J. Bejček due managerial care includes "proper care, diligence and loyalty to the interests of a company." Loyalty is considered to be a part of due managerial care. This author maintains that the interpretation of loyalty corrects the principle of diligentia quam in suis and that the company's interests are always superior. The director must then manage the company as he would manage her own affairs. "With resignation on her personal interests if they could conflict with the interests of the company,"[30]

The Supreme Court upheld that "*a part of due managerial care is that the member of the board of directors prefers....the interests of the company over those of the shareholder who placed him in the function....and does not allow himself to be influenced* (loyalty obligation) *by this shareholder during performance of his duties.*"[31]

I. Pelikánová explains that due managerial care can be interpreted as such a performance of function that "*respects legal regulation, company's articles and guidelines of the general meeting, as well as the legitimate interest of the company.*"[32] The Supreme Court made it clear that a duty of the person acting with due managerial care is to be informed regularly on financial results of the company[33].

[26] Černá, S.: Obchodní právo. Akciová společnost, Praha: ASPI, 2006, p. 244.
[27] Decision of the Supreme Court of the CR, docket number 5 Tdo 1412/2007.
[28] Decision of the Supreme Court of the CR, docket number 5 Tdo 1143/2005.
[29] Čech, P.: Péče řádného hospodáře a povinnost loajality, Právní rádce, 2007/ 3, p. 4.
[30] Bejček, J.: Principy odpovědnosti statutárních a dozorčích orgánů kapitálových společností, Právní rozhledy, 2007/ 17, p. 614 and 615.
[31] Decision of the Supreme Court of the CR, docket number 29 Cdo 3864/2008.
[32] Pelikánová, I.: Obchodní právo, 1. díl, CODEX, 1998, p. 446.
[33] Decision of the Supreme Court of the CR, docket number 5 Tdo 1152/2006.

If I attempt to create a synthesis of the academic opinions and the Supreme Court decisions, it is clear that the standard of due managerial care expected from the member of the board combines objective elements (compliance with the law, preference of the interests of the company, expertise) with subjective elements (diligence, conscientiousness, organisational skills, creative thinking, activity, ability to take risks). It can be concluded that the standard of due managerial care can be seen as both objective and subjective standard of care.

One component of due managerial care is the duty of confidentiality, which is mentioned separately in § 194 (5) of the Commercial Code. But indeed the duty of due managerial care, interpreted extensively, will include all the other duties of directors contained in the Commercial Code. Due managerial care in this relation is understood as a qualitative criterion of the level of care that must be fulfilled when performing any activity as the member of the board of directors or supervisory board.

I want to mention the oversight/monitoring duty of directors at this point. The Czech Commercial Code has nothing to say about this duty. But as it is clear from the above text, this duty can be interpreted as forming a part of the duty of due managerial care.

2. Duty to follow the principles and instructions of the general meeting

It is stated in § 194 (4) that "the board of directors shall follow the principles and instructions approved by the general meeting, provided that they conform to the statutory provisions and the articles." I. Pelikanová comments that this would be true even without the express provision of the Commercial Code. Indeed, the general meeting is conceived as the supreme organ of the company. The conformity of decisions of the general meeting with legal regulation and articles only repeats the law. It then follows that such an instruction of the general meeting which is contrary to law or articles is not binding for the board of directors[34].

It was confirmed in the decision of the Supreme Court that "*the director is liable to the company for damage caused by breach of due managerial care, which he causes by fulfillment of an instruction of the general meeting when the instruction of the general meeting is in conflict with the law.*"[35]

3. Prohibition of competitive conduct

Specific duty of the members of the board of directors is to comply with the prohibition of competition. This is how the Czech law deals with the problem of "corporate opportunities", i.e. the situation when the director takes advantage of a business opportunity that 'belongs' to the company.

Essentially, the members of the board must not engage in any activity which could compete with the interests of the company. The Commercial Code contains the general prohibition of competitive conduct in § 65 and § 196 (1) stipulates in detail activities which cannot be undertaken by a member of a limited liability company's board of directors. According to this section, "unless the articles or a

[34] Pelikánová, I.: Obchodní právo, 1. díl, CODEX, 1998, p. 447.
[35] Decision of the Supreme Court of the CR, docket number 7 Tdo 1396/2008.

resolution of the general meeting impose further restrictions, a member of the board of directors can not

(a) Carry on a business activity in an identical or similar line of business as the company or enter into business relations with the company;

(b) Act as an intermediary (broker, agent) for other persons in transactions with the company;

(c) Participate in the business activity of another entity as a partner with unlimited

liability or as a person controlling other persons engaged in an identical or similar line of business activity; and

(d) Act as, or be a member of, the statutory organ of another legal entity engaged in an identical or similar line of business as the company, unless such legal entity is a holding-type group"

The prohibition of competitive conduct is formulated to prevent situations where the interests of board members clash with the interests of the company and which could bring the risk that a member of the board gives priority to his own benefit at the expense of the company[36]. What is an identical or similar line of business must be, according to J. Pokorná, always assessed according to facts of the particular case.[37]

The articles or the resolution of general meeting can extend this prohibition of competitive conduct, but the statutory prohibition cannot be narrowed or excluded.

4. Protection in case of conflict of interests

The competition between the interest of the company and the interest of a defined group of individuals can occur in other situations too. The Commercial Code therefore contains a special provision for contractual arrangements between the company and members of the_board. The problem of "self-dealing", i.e. the problem of transactions between the director and her company, is addressed in § 196a of the Commercial Code. In practice the interpretation of this provision of the Commercial Code causes considerable problems.

According to § 196a (1) a company may "*only conclude a credit or loan contract with a member of its board of directors, supervisory board, attorney or another person authorized to act in the name of the company, or with persons close to them, or a contract on securing the obligations (debts) of these persons, or a contract for free-of-charge transfer of property from the company, with the prior approval of the general meeting and only under the conditions usual in trade.*"

The reason is to protect the company against possible misuse of the power to act in the company's name. The Supreme Court specified in its decision that the "*the provisions of § 196a (1) and (2) of the Commercial Code are to prevent the person who may influence conditions of concluding a specific contract from profiting from this position she holds personally or by means of persons close to her to*

[36] Pelikánová, I.: Obchodní právo, 1. díl, CODEX, 1998, p. 452.
[37] Pokorná, J., Večerková, E.: *K zákazu konkurenčního jednání v obchodních společnostech – vymezení pojmu konkurenčního jednání*, ASPI.

the detriment of the company."[38] Reinsurance of a claim of a person listed in § 196a (1) of the Commercial Code in conflict with this provision forms absolute invalidity of the negotiated reinsurance[39].

Person authorised to act on behalf of more parties

In practice it can also happen that a particular person acts on behalf of the joint-stock company as the member of the board of directors and is entitled to conclude contracts on behalf of the other contracting party too. In this particular case there is again an undesirable conflict of interest. The Commercial Code deals with this situation in § 196a (2), which says that "should the persons under subsection (1) also be authorized to act in the name of another person, the provisions of subsection (1) shall apply, as appropriate, to any performance (payments) stipulated therein in favour of such persons." In this case too such a contract must be approved by the general meeting and its terms and conditions must be usual in trade in order to be valid.

An exception to this rule is a credit or loan granted by the controlling person to the controlled person, or if the controlling person is to secure obligations (debts) of the controlled person, in which case the approval by the general meeting is not required. But even in this case, the condition that the contract must be under the conditions usual in trade must still be fulfilled.

Asset transfer

If the company acquires assets from the above defined group of people or if it transfers assets to them for consideration and if the value of such assets (consideration) exceeds one-tenth of the capital of the company, it is provided in § 196a (3) that it "can be only done at a price determined by an expert and only with the prior consent of the general meeting." Exception is again an acquisition of assets by a controlled company from the controlling company. Likewise this provision does not apply when the company acquires property from a shareholder in case of the increase of share capital or the shareholder from the company, when the company reduces its share capital.

According to § 196a (4) "the provisions of subsection (3) shall not apply to property acquired within the framework of customary business transactions or to any acquisition initiated or supervised by a state authority or to property acquired on a stock exchange or similar public market. The provisions of subsection (1) on approval by the general meeting shall similarly apply to a free-of-charge transfer of property to a shareholder ("bezúplatný převod majetku na akcionáře")."

It is stated in § 196a (5) that "the provisions of subsections (1) to (3) shall also apply to the assumption of suretyship."

[38] Decision of the Supreme Court of the CR, docket number 29 Cdo 1780/2008.
[39] Decision of the Supreme Court of the CR, docket number 29 Odo 91/2003.

4 LIABILITY FOR BREACH OF DUTY

- Liability for breach of duty to exercise powers with due managerial care and confidentiality and duty to follow the principles and instructions of the general meeting

If the duty to exercise powers with due managerial care and confidentiality and the duty to follow the principles and instructions of the general meeting are breached, the member of the board of directors is according to the Commercial Code liable to pay damages to the company. In addition to the legal consequences of the breach, other consequences can be specified in the articles or the contract between the member of the board and the company.

It is provided in the third sentence of § 194 (5) of the Commercial Code that "members of the board who caused damage to the company by breaching their legal duties while exercising their powers shall be liable for such damage jointly and severally." According to § 66 (2) and § 261(3)(f) of the Commercial Code the relationship between a member of the board of directors and the company has a commercial character.[40] It then follows that the legal regime for liability of such members for damages is commercial in nature. The general provisions of the Commercial Code on damages as codified in § 373 et seq. will be applied to breach of directors duties with specified variations.

General conditions for liability under Commercial Code are:

1) breach of legal duty
2) loss (damage)
3) loss causation (a causal link between the breach and the loss)
4) no circumstances excluding liability

Loss (damage) is understood as a damage which can be expressed in money worth and is recoverable in cash or in kind. It is specified in § 380 that "damage is also considered to mean a loss which the aggrieved party suffered by having to expend resources as a result of a breach of duty by the other party." According to § 379 the loss means both the actual damage and the lost profit.

- Objective standard

The Commercial Code generally applies strict (objective) liability. This means that the director is responsible for the result regardless of subjective mental element ("guilty mind"). If the duty is breached by more than one member of the board, then these members are liable for such damage jointly and severally. However, only those members of the statutory organ who breached their duty are liable. This does not concern collective liability of all members of the statutory organ.

[40] § 66 (2) of the Commercial code says that "the relationship between the company and the person who is its statutory organ, or a member of its statutory organ..... shall be subject to the provisions on mandate". § 261(3)(f) of the Commercial Code specifies that the Commercial Code irrespective of the nature of the parties regulates *inter alia* obligations "*between the company or co-operative and the person being its statutory or other organ or its member*".

- Burden of proof

It is stated in the second sentence of § 194 (5) that "if there is a dispute about whether a particular member of the board of directors exercised due managerial care, the burden of proof ("*onus probandi*") shall be borne by such member." The burden of proof is therefore legally transferred from the company directly to the member of the board of directors. In practice this has the following effect: if the company claims damages in court against the member of the board of directors for breach of her duty to exercise due managerial care it needs not to prove this. It suffices to claim such a breach and it is up to the director to present evidence to the court and prove that she did not breach her duty to exercise due managerial care[41].

- No exclusion of liability in contract or articles

It is expressly stated in the fourth sentence of § 194 (5) that "a contract between the company and a member of the board of directors, or articles, which exclude or limit the liability of a member of the board of directors, are null and void." Such arrangements will always be invalid and will have no legal relevance.

- No court mitigation

It is provided in § 386 (2) of the Commercial Code that the "the court may not reduce the amount of damages" and generally that the right to damages may not be waived prior to the breach of an obligation (duty) from which damage may arise.

- <u>Circumstances excluding liability</u>

General regulation excluding liability for damage:

The Commercial Code generally regulates the circumstances excluding liability for damage in § 374. According to § 374 (1), circumstances excluding liability are "*an obstacle which arose independently of the obligated party's will and that prevents it from performing its obligation, provided that it cannot be reasonably expected that the obligated party could avert or overcome such an obstacle or its consequences, and further that the occurrence of such an obstacle was unpredictable at the time when the obligated party undertook to perform such obligation.*"

The general regulation thus points mainly towards situations that we could term events of *force majeure*, for which a certain general objective level of care and attention is expected, which every entrepreneur must possess regardless of his personal activity. The law thus regulates a relatively strict variation of liberation in which there is no room for considering the personal conduct of the one causing damage.

When comparing the quoted general regulation and the regulation of liability for damage amongst members of statutory organs of commercial companies it is clear that the due diligence (care) criterion, though such diligence is expressed as an objective level of care relating to the function of a member of a statutory organ, takes into account the individual conduct of the liable person. A reliable answer to the question of whether or not a member of a statutory organ exercised the necessary level

[41] Pelikánová, I.: Obchodní právo, 1. díl, CODEX, 1998, p. 448.

of care can indeed only emerge after examination of his actions in the given matter, where it is necessary to judge an entire series of circumstances - whether he acquired the necessary information, whether he considered possible risks of the particular matter, whether he prepared multiple variations of how to proceed and if he adopted assurance measures.

Thus, one expects that the member of a statutory organ could predict certain obstacles and that these obstacles need not be irreversible and impossible to overcome. On the contrary, it is desirable for such a member to perform the necessary preventative measures. If the negative development of the case does occur, a sufficient level of care leads to exclusion of his personal liability for consequences. The general regulation of exclusion of liability for damages should thus be applied only in such cases where the damage was caused by unpredictable and irreversible events which were not possible to objectively prevent.

Special regulation

1. The Commercial Code excludes in its § 194 (5) last sentence the liability of the members of the board of directors of the joint-stock company for "damage caused by their execution of a specific instruction of the general meeting if such instruction was contrary to the statutory provisions." Compliance with the instruction of the general meeting, which is contrary to law, are members of the board of course obliged to refuse. However, if the member of the board carried out such an instruction, she will be liable to the company for the loss incurred.

2. Liability of members of the board of directors for damages is also excluded if:

-Instruction of the general meeting was lawful;

- At least one member of the board drew attention to the inappropriateness of the instruction

(the instruction is lawful, but its implementation is likely to have adverse consequences for the company);

- At least one board member asked for this objection to be included in the minutes of the meeting; or

- General meeting confirmed the instruction[42].

If all the conditions are met, the members of the board are not liable to the company for the loss caused by carrying out the instruction of the general meeting.

This provision is essentially a warning to the general meeting not to give instructions with likely adverse economic consequences and protection of the members of the board in such a situation.

3. If the law or articles require that specific action of the board of directors requires prior approval of the supervisory board or if the supervisory board exercises its right to prohibit the board of directors from undertaking specific action in the name of the company, then according to § 201 (4) "the members of the board of directors shall not be responsible for any damage resulting from its compliance." Members of the supervisory board who voted in favour of such decision (resolution) shall be jointly and severally responsible for the damage thus caused if they did not act with due managerial care.

[42] Pelikánová, I.: Obchodní právo, 1. díl, CODEX, 1998, p. 448.

- Statutory limitation

The normal limitation period contained in the Commercial Code is according to § 397 four years and this statutory limitation period applies to a claim of the company against the member of the board of directors. In § 398 is specified that "in case of the right to claim the damages, the period of the statute of limitations begins to run from the day when the aggrieved (injured) party learned, or could have learned, of the damage and of the identity of the party liable for its compensation; however, it shall expire no later than ten years from the day when such a breach of duty occurred."

- Liability for breach of prohibition of competitive conduct

In case the member of the board of directors engages in activities prohibited by § 196, then according to § 196 (2) "any violation of the above provisions shall bear the consequences set out in § 65." The competitive conduct is generally prohibited in § 65 (1) and § 65 (2) details the legal consequences for violation of this prohibition. According to § 65 (2) "a company may claim that the person who violated this prohibition surrenders to the company any benefit gained from the transaction by which he violated the prohibition, or that he transfers the corresponding rights to the company. This shall not affect the right of the company to claim damages."

For example, if the member of the board of directors of the company active in an advertising business signs a contract for an advertising campaign, the company has a right to demand the payment obtained or the right to require the transfer of right to reimbursement (if the price has not been paid) and simultaneously claim the damages for the breach of director's duty.

- Statutory limitation

The company's rights under § 65 (2) shall become according to § 65 (3) null and void "if they are not claimed against the individual within three months of the day on which the company learns of the relevant fact; however, a claim cannot be made later than one year after the day when the prohibition is violated. This shall not, however, affect the company's right to claim damages."

- Liability for breach of statutory provisions on conflict of interests

The consequence of breach of statutory provisions on conflict of interests described in §196a of the Commercial Code is an absolute nullity of such an action according to §39 of the Civil Code. If as a consequence of the breach the company suffered loss, it can claim the damages against the member of the board too.

Warranty of a person with influence

According to § 66c of the Commercial Code anybody who by means of his influence in a company "makes a person who is such company's statutory organ or a member of such, or a member of the company's supervisory organ or another authorized person to act to the detriment of the company or to the detriment of the company's members (shareholders), warrants (as a guarantor) the payment of damages to the company."

Payment from the company

Any payment by a company to a person who is its statutory organ or member of such an organ, which this person is not entitled to under the statutory provisions or the articles, is subject to approval by the general meeting, unless the person was awarded the right to such payment in a contract. However according to § 66 (3) the company "shall not provide such payment if this person's performance of her office obviously contributed to the company's unfavourable economic results or if this person breached her statutory duty."

Although the director has a proper legal title for a payment, § 66 (3) second sentence prohibits such a payment if his activity led to deteriorating economic performance of the company - a causation must be clear - but it is not necessary for the damage to be present. It is sufficient that the company is unprofitable or that the company does not reach the normal level of profit. This provision prohibits such a payment also in a case when the director intentionally or negligently breached her duties. The company has to prove the breach.

Insurance

The Czech Commercial Code doesn't mention the Directors and Officers liability insurance (D&O insurance), but number of such products are available on the market. The statutory personal liability of the members of the board of directors and the supervisory board is one of the greatest risks faced by top executives; these members are liable with all their property for damage to the company arising from the breach of their statutory or contractual obligations (duties). The contract between the company and such a member excluding or limiting liability is legally invalid.

The voluntary D&O insurance is offered by a number of insurance companies and there is a wide choice of insurance policies.

5 DUTIES IN THE VICINITY OF INSOLVENCY

In Czech law, director's duties are not generally speaking owed to creditors. However, the creditors' interests in case of insolvency of the company are protected by provisions of the Commercial Code and the Insolvency Act[43]. In case of insolvency the directors duties don't change, but the directors acquire three new duties. First is the duty to convene general meeting. Second is the duty to pay creditors under certain circumstances. And third is the duty to start the insolvency proceedings.

1. Duty to convene general meeting

When the total unsettled loss of a joint-stock company represents one half of its registered (share) capital or the company becomes insolvent, the board of directors must according to § 193 (1) of the Commercial Code convene a general meeting of shareholders without undue delay. When the company becomes insolvent, the board of directors "will recommend to the general meeting to wind up the company or adopt another measure, unless other statutory provisions specify otherwise." At the general meeting the board of directors must propose how to settle the loss or that the company is wound up and liquidated, unless the filing of an insolvency petition is required by law. Insolvency proceedings are subject to the Insolvency Act.

2. Liability of the director as surety

The Commercial Code strengthens the protection of creditors of the company by giving them the right, under certain conditions, to claim money owed to them by the company from the members of the board of directors. It is stated in § 194 (6) that "members of the board of directors, who are responsible to the company for loss, shall be jointly and severally liable as sureties if the board member didn't pay the loss to the company and creditors cannot satisfy their claims from the company's property due to its insolvency or because the company stopped making payments. The extent of such liability shall be limited by the amount of loss which is payable to the company. Liability of the board's member is discharged when she pays up the loss."

The surety arises when:

a) The member of the board is obliged to pay damages to the company, but the company didn't claim such damages, or

b) The creditors are unable to satisfy their claims form the company assets due to its insolvency or because the company stopped making payments.

[43] Act No. 182/2006 Coll. on bankruptcy and settlement (Insolvency Act).

(zákon č. 182/2006 Sb., o úpadku a způsobech jeho řešení (insolvenční zákon)).

Both conditions must be fulfilled cumulatively. The liability of the member of the board as a surety is limited by the extent of her liability to the company for the breach of duty. The casual link between the breach of duty and the claim of creditors is not required for the surety to arise.[44]

Since the surety is subsidiary in nature, the creditor can request the performance (payment) from the member of the board only after her claim against the company was unsuccessful (§ 306 of the Commercial Code).

3. Duty to start insolvency proceeding

A debtor is according to § 98 (1) of the Insolvency Act obliged to "file an insolvency petition without undue delay after he learnt or ought to have learnt about the insolvency/" This duty has, according to § 98 (2) of the Insolvency Act, members of the statutory organs. In case of a joint-stock company this means both members of the board of directors and members of the supervisory board. It is expressly stated in this subsection that this duty has each and every member.

Insolvency

The Insolvency Act defines insolvency ("úpadek") in § 3. Subsection one, in my opinion, describes the cash flow based system in determining insolvency. According to § 3 (1) the debtor is insolvent if "he has:

a) More creditors and

b) The financial obligations are more than 30 days overdue and

c) He is unable to pay the debts."

What the inability to pay debts means is specified in § 3 (2). This section states that it is understood that the debtor is unable to pay his debts if:

a) He stopped making payments for a substantial part of his financial obligations

or

b) Yhe payments are not made for more than three months after their due date.

Balance sheet insolvency is dealt with in § 3 (3) of the Insolvency Act. According to this section a debtor who is a legal entity or a natural person - entrepreneur is insolvent when he is heavily indebted ("předlužení"). Heavy indebtness means that "the debtor has several creditors and the sum of its liabilities exceeds its assets." In determining the value of a debtor's assets, the management of its asset must be taken into account.

Board of Directors

It is provided in § 99 (1) of the Insolvency Act that any person (for joint-stock company any member of the board of directors or the supervisory board) who in contravention of § 98 did not file an insolvency petition is liable to creditors for damages or other loss caused by the breach of her duty. According to

[44] Pelikánová, I.: Obchodní právo, 1. díl, CODEX, 1998, p. 450.

§ 99 (2) damage or other loss is "the difference between the amount of creditor's claim in the insolvency proceeding and the amount of money the creditor received".

Exemption

A person liable for damages or other loss under subsection 2 of § 99 of the Insolvency Act can be exempted from liability only if she proves according to § 99 (3) "that the breach of her duty to file an insolvency petition did not affect the amount of money available to creditors or that she breached her duty due to facts that occurred independently of her will and which she could not turn away by exerting all efforts that can reasonably be required."

6 ENFORCEMENT OF DUTIES

Director's duties are owed to the company and therefore the company is the proper plaintiff in case of breach of duties. The board of directors should claim the damages against the member of the board of directors. This is commanded by their duty to act with due managerial care. It is clear, however, that the implementation of this requirement can be problematic in practice, especially when all the members of the board breached their duties.

The Commercial Code protects the company by imposing an obligation on the supervisory board to claim the damages on a proposal from minority shareholders. According to § 182 (1) c) of the Commercial Code "at the request of the shareholder or shareholders referred to in § 181 (1) the supervisory board will assert any right for damages which the company has against a member of the board of directors."

The supervisory board may be requested by the minority shareholders to claim damages against a liable member of the board of directors in the name of the company. In proceedings before the court the designated member of the supervisory board represents the company as required by § 199 (2) of the Commercial Code.[45]

The minority shareholder(s) empowered to make such a request are specified in § 181 (1) of the Commercial Code as "a shareholder or shareholders of a company whose registered share capital is higher than CZK 100 million and who have shares with a total nominal value exceeding 3% of the registered capital, and also a shareholder or shareholders of a company whose registered capital is CZK 100 million or less and who have shares with a total nominal value exceeding 5% of the registered capital."

Should the board of directors or the supervisory board fail to comply with requests made by the minority shareholder(s), the shareholder(s) can bring a derivative action. This is a lawsuit brought by a shareholder in the name of the company against the director of the company for failure to perform her duties. In Czech law the shareholders cannot sue the director in their own name.

The derivative action is codified in § 182 (2) of the Commercial Code which states that "should the supervisory board or the board of directors fail to comply with a request by a shareholder(s) <u>without undue delay</u>, such shareholder(s) (as described in § 181(1)) may assert the right to damages." The right to damages is asserted by filing a claim with the competent court and acting as legal agent for the company. The Commercial Code also requires that "a person other than a shareholder who filed such a claim, or a person authorized by him, may not perform acts in the proceedings for the company or in the name of the company."

[45] § 199 (2) of the Commercial Code provides: "The supervisory board shall appoint one of its members to represent the company in proceedings before courts and other authorities against a member of the board of directors."

7 CONFLICT OF LAWS

- Private international company law

The Czech Commercial Code contains the conflict of laws rule based on the incorporation theory. The incorporation theory determines the applicable company law by reference to the country in which the company was incorporated. The connecting factor is the country of incorporation. According to § 22 of the Commercial Code, "under Czech law, the legal capacity of a foreign person other than a foreign individual is determined by the law under which such person was established. This law also governs the foreign person's internal legal relations and its members' or partners' liability for the person's obligations."

In Czech law, the legal capacity of a foreign person (company) and its internal relations are governed by the foreign law. It is specified in § 21 (2) of the Commercial Code what the foreign person (company) means. Foreign person (company) is according to this section "a legal entity whose seat is outside the territory of the Czech Republic." Although the law uses the term "seat," it does not imply the real seat theory and in my opinion it would be more appropriate if the legislator used the term "place of incorporation."

The incorporation theory means that the provisions of the Czech Commercial Code apply only to companies incorporated according to Czech law. Foreign companies are being governed by the law of the state of their incorporation. In relation to directors' duties this means that the duties codified in the Czech Commercial Code will only apply to a director of a company incorporated under Czech law. The statutory duties don't apply to directors of a company incorporated abroad.

The Code stipulates the principle that a foreign company may operate on the territory of the Czech Republic under the same conditions and to the same extent as a Czech company, unless the law states otherwise. A foreign company's authorisation to carry on a business activity on the territory of the Czech Republic takes effect, in accordance with § 21 (4), "on the day as of which that person is registered in the Czech Commercial Register." Such foreign company is authorised to engage in the range of business activities specified in the entry in the Commercial Register. The application for this is filed by the foreign company concerned.

- Private international insolvency law

A special conflict of laws rule for insolvency proceeding is mentioned in the Insolvency Act. The insolvency proceeding with the European cross-border element and its effects are according to § 426 of the Insolvency Act to be "governed by the directly applicable law of the European Union." The Insolvency Act in this provision refers to the Insolvency Regulation.[46]

The Insolvency Regulation applies to insolvency proceedings, whether the debtor is a natural person or a legal person, a trader or an individual. It is necessary for the proper functioning of the internal

[46] Council Regulation (EC) No 1346/2000 on insolvency proceedings (Insolvency Regulation).

market that cross-border insolvency proceedings should operate efficiently and effectively. In order to achieve this objective the Insolvency Regulation enables the main insolvency proceeding to be opened in the Member State where the debtor has the centre of main interests (COMI). Article 3 (1) provides that "the courts of the Member State within the territory of which the centre of a debtor's main interests is situated shall have jurisdiction to open insolvency proceedings." According to section 13 of the preamble the COMI "should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties."

Article 4 of the Regulation describes the applicable law. According to this article "the law applicable to insolvency proceedings shall be that of the Member State within the territory of which such proceedings are opened." If the insolvency proceeding is opened in the Czech Republic, then the Czech insolvency law will be applied. This special conflict of law rule applies only to conflict of law with the European element i.e. only to proceedings where the centre of the debtor's main interests is located in the Community.

LSE Enterprise

DIRECTORS' DUTIES AND LIABILITY IN DENMARK

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CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in Denmark

Danish law is considered to belong to a legal system which differs from both civil law and common law. The Nordic countries, including Denmark, are generally perceived to constitute a special legal family influenced by both continental European and common law tradition. The importance of statutory legislation places the Nordic legal system closer to the civil law Continental countries, but legislation tends to be short and there is an absence of the larger codifications that characterise Continental civil law. The importance of case law to establish the meaning of statutes resembles somewhat common law traditions, though to a lesser extent, as does the lack of significance of legal formalities that is a characteristic of the Nordic legal systems, which is also marked by an absence of modern codes in the field of private law.[1]

The Danish Companies Act of 2009 (hereinafter "the Danish Companies Act"), regulates how companies are to be formed and their governance. Danish public and private limited companies used to be governed by separate acts as in Germany, where the inspiration came from, to distinguish between public and private companies. This distinction was unknown in Danish law until accession to the then EEC in 1973. By the 2009 Act, both company forms are now governed by the same statute, which reflects the decreasing importance of the difference between public and private companies. The Danish Companies Act came into full effect on 1 January 2011. A major novelty in the new Act is the introduction of a German inspired two-tier governance structure consisting of a Board of Management and a Board of Supervisors to supplement the traditional dual-executive system which operates with two executive bodies, one being the Board of Directors and the other the Board of Managers, which originated in the Danish 1930 Companies Act and which was later adopted by the four other Nordic countries of Finland, Iceland, Norway and Sweden. The dual-executive system is still the dominating governance structure in all five Nordic countries and in it, the Board of Directors is the senior and central executive organ, whereas the Board of Managers is charged with the day-to-day management and must follow instructions from the Board of Directors. In this respect, the dual executive system resembles the distinction introduced into English company law by the 1992 Cadbury Report between executive and non-executive directors. The new two-tier structure introduced by the 2009 Act was German-inspired but is hierarchical and thus provides considerably more power to the Board of Supervisors, notably the power to fire managers at will, than in the German system. Thus, the new Act enables shareholders of Danish limited liability companies to choose between two different board structures, although the new two-tier structure has so far only been used by very few companies. As the introduction of the Danish Companies Act did not result in any substantive changes to directors' duties and liability, case law, which was decided before the enactment of the Act, is still relevant.

In addition to the Danish Companies Act, the activity of the company may determine whether the company is subject to other forms of regulation, e.g. securities regulation. Financial institutions, e.g. banks, are formed as public limited companies and as such are subject to the Companies Act, but they are also to a large extent subject to special regulation by way of the Act on Financial Institutions.

[1] Ditlev Tamm, *The History of Danish Law* (DJØF Publishing, 2011).

Another significant means of regulation in Denmark is the Danish Corporate Governance Code. Since the introduction of the Code in 2001 it has been revised several times, and the Code that applies at present was published in August 2011. Whilst the Code itself is not binding, listing rules for the regulated market NASDAQ OMX Copenhagen require companies to give a statement in their annual report on how they address the Recommendations on Corporate Governance issued by the Committee on Corporate Governance. This statement should explain whether the company has complied with the principles. If it has not, reasons must be given for the non-compliance (principle of comply or explain).[2]

Preparatory works, especially the comments in legislative proposals, constitute an important legal source in Danish law. As the lexical meaning of a word might be ambiguous or unclear, preparatory work is often a useful tool when determining the meaning of a provision.

Case law is also of major importance within Danish law, particularly where the Danish Companies Act does not contain detailed regulations or where only basic principles are provided. This is, for example, the case with regard to tort law, e.g. the determination of when a director is in breach of his fiduciary duties. Courts generally take earlier decisions into account where the same or similar issues arise in subsequent cases. The decisions of the Danish Supreme Court have the greatest persuasive value because that court is the highest appellate court in the country. The lower courts, which are the two High Courts for appeal and the city courts that serve as first instance, normally follow Supreme Court decisions which have been decided on a similar issue. The findings of Danish judges are often only very briefly stated in comparison to English and American decisions.

Finally, legal theory is also of importance with regard to the interpretation of Danish acts.

As Denmark is a part of the European Union, EU law applies and large parts of Danish law must be construed by reference to the underlying principles stemming from EU law.

1.2 Corporate landscape in Denmark

The Danish Stock Exchange is part of NASDAQ OMX Nordic, which also includes the stock exchanges of Helsinki, Stockholm, Iceland, Tallinn, Riga and Vilnius.[3] The market capitalisation of NASDAQ OMX Copenhagen was on the last trading day of 2011 DKK 1,090 billion and there are over 200 listed companies in Denmark.[4]

The Danish capital market is characterised by public listed companies that are to a wide extent held by block holders. Another distinctive feature in Denmark is the foundation-owned company, which presents particular issues of governance, has no owners and hence no external parties to monitor the board of the foundation.[5] However, empirical studies suggest that these companies traditionally perform very well.[6] The prevalence of dominant owners has influenced the perception of Danish

[2] Section 4.3, Recommendations on Corporate Governance, August 2011.
[3] NASDAQ OMX Nordic, http://www.nasdaqomxnordic.com/about_us?languageId=5.
[4] Politikken, http://politiken.dk/indland/ECE1494186/aktionaerer-tabte-234-milliarder-paa-danske-aktier-i-2011/.
[5] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[6] Steen Thomsen and Caspar Rose, *Foundation Ownership and Financial Performance*, The European Journal of Law and Economics, 18: 343-364 (2004).

corporate governance, which emphasises the beneficial influence of dominant shareholders to monitor and discipline management in the interest of all shareholders, so-called 'active ownership'. The law secures that dominant owners may influence management, notably it is required that a majority of the Board of Directors at all times are appointed by the shareholders in general meeting and can be dismissed at will, which ensures the actual control of a dominant shareholder over management. Provisions of securities regulation on publicly traded companies, e.g. on inside information, are interpreted to allow for deliberations in confidence between dominant owners and management. Thus, in Danish company law questions of good corporate governance is less a matter of owner influence over management, but of minority protection vis-à-vis controlling shareholders. This protection is mainly based on provisions in the Danish Companies Act and upheld by the courts, and it is generally viewed as effective.

The Danish Companies Act is applicable with regard to state-owned public limited companies, i.e. companies where the state is a controlling shareholder. This is an unusual feature in Denmark in respect of major companies and the Companies Act tries to put in place the same governance system that is applicable to publicly traded companies. The Companies Act contains special provisions regarding state-owned companies. For example, general meetings must be open to the press, the auditor elected by the company must attend the annual general meeting, and the company must establish internal guidelines.[7] There is no special regime in relation to directors' duties and responsibilities. The activities and privatisation of an individual state-owned public limited company is often regulated by a separate act. If the state-owned company is publicly traded, i.e. it has its securities admitted to trading on a regulated market, these particular provisions of the Companies Act do not apply, whereas the Danish Securities Trading Act applies.

1.3 The board of a Danish company

Section 111 of the Companies Act provides for two different corporate governance models. The first is a one-tier model that distinguishes between two levels of executives: the Board of Directors (bestyrelse) and the Board of Managers (direktion). It is, therefore, known as the dual-executive model and is the traditional governance structure applied in all five Nordic countries. The Board of Directors are the central executive organ engaged with overall strategy governance, whereas the Board of Managers is responsible for day-to-day management and carrying out the instructions of the Board of Directors. The distinction between directors and managers resembles that of executive and non-executive in English company law and it should be noted that directors enjoy executive powers besides their power to monitor managers. In Denmark, where the dual-executive system originates, the Board of Managers is a collective body consisting of one or more managers of whom one would be the CEO (administrerende direktør), whereas in Finland, Norway and Sweden management consists only of the CEO, nevertheless the distribution of powers between the two levels of executive bodies are the same. The other model is a German inspired two-tier model, which operates with a single Board of Managers (direktion) under the supervision of a non-executive Board of Supervisors (tilsynsråd). Although inspired by German law, the structure is moulded by the Danish tradition for strong ownership influence and is consequently structured as a strict hierarchy where the Board of Supervisors discretionally can hire and fire the managers, which makes it much more influential than in German law. The two-tier model was only recently introduced with the Companies Act of 2009 and

[7] The Danish Companies Act, sections 76(3), 103(4), 357.

is still rather unusual. Thus, the dual-executive system will be referred to as the traditional Danish model.[8]

Both models are subject to a strict hierarchy. The shareholders in general meeting decide which model should be specified in the articles of the company. The general meeting must appoint the majority of either supervisors or directors and can dismiss them at will. The managers are hired and may be fired at will by either the Board of Directors or the Board of Supervisors. Note, that while directors or supervisors are appointed by the general meeting, usually for a term of one year to the next general meeting, managers are hired by contract. Thus, whereas managers may be fired immediately, supervisors or directors can only be dismissed upon the congregation of a general meeting. However, as an extraordinary general meeting may be summoned quite quickly, there is little difference. The possibility for a higher level of removing officers from a lower level ensures that a strong hierarchy is enforced by which the upper level may instruct the lower level and can remove any member that does not comply sufficiently. The hierarchy also relies on the prevalence of dominant shareholders who can and will engage regularly with management and discipline them if necessary. This is known as active ownership by the shareholders, which is encouraged by the Companies Act. Other stakeholders may appoint directors or supervisors, notably the employees who can appoint up to one third of the board, although a survey from 1999 found that only 20 per cent of companies that could have employee representation had in fact chosen to implement it.[9] The Articles of a company may provide the right to appoint directors to a private person or public body, but this is very unusual. The Act ensures that at least half of the board is made up of directors or supervisors appointed by the shareholders in general meeting. This effectively gives the shareholders direct control over the board, as the board takes its decisions by simple majority.

The two different models rely on a distinction between directors and executives. The traditional Danish model is seen as a one-tier system in spite of the distinction between directors and managers. Its character as one-tier system becomes evident if all the managers serve on the Board of Directors, which is possible since the model allows for double mandates, although a majority of directors cannot also serve as managers. Thus, the dual-executive model known since 1930 is more akin to the distinction between executive directors and non-executive directors introduced in English company law by the 1992 Cadbury Report. The dual-executive model expects a director to perform two tasks: to run the company, especially with regard to long-term and strategic considerations, and to supervise the Board of Managers that executes the decisions and serves under its instructions. As the Board of Directors is seen as the upper level of management, the directors enjoy executive powers and may sign contracts on behalf of the company. The chair of the Board of Directors normally serves as the face of the company to the outside world, unless the company is very large in which case it may be represented by the CEO. Besides their executive powers, directors must supervise the managers. For this reason, although double mandates are allowed in the traditional dual-executive system, the number of managers, if any such are appointed as directors, must be less than half of the total board and a manager cannot serve as chair of the Board of Directors.[10]

The new two-tier model is inspired by German law. Although the Board of Supervisors enjoys no executive powers it is considered to be above the Board of Managers, notably due to its power to hire

[8] Jesper Lau Hansen, *The Danish Green Paper on Company Law Reform—Modernising Company Law in the 21st Century'* (2009) 10 EBOR 73 and Jesper Lau Hansen, *The New Danish Companies Act*, (2010) 11 EBOR 87.
[9] Erhvervsministeriet, *Debatoplæg om aktivt ejerskab*, May 1999, p. 166 [Report on governance conducted by a number of Danish ministeriums]
[10] Danish Companies Act sec. 111(1)(1).

and discretionally fire any manager. This should provide the Board of Supervisors of a Danish company with a considerably stronger position than its German counterpart. In the two-tier system, double mandates are not allowed and consequently the Board of Managers is expected to report regularly to the Board of Supervisors to keep the supervisors informed. As the Board of Managers is the only Board of Managers in this model, the managers must take care of both day-to-day management as well as long-term strategic planning that would be placed with the Board of Directors in the dual-executive system.

The public limited company is bound by agreements made on behalf of the company by the Board of Directors, by a director or by a manager. In contrast, members of the Board of Supervisors, if a two-tier structure is in operation, have no power to bind the company.[11] The company can decide to restrict the executives' powers to bind the company in the articles of association, and many Danish companies do this, however no restrictions can be placed on the entire Board of Directors. If the company does not wish to restrict the powers conferred on the executives in the Act, the legal right to bind the company towards third parties will follow from the registration of the directors with the Danish Business Authority (Erhvervsstyrelsen).[12]

[11] The Danish Companies Act, section 135(2).
[12] LFF2008-2009.1.170, p 126.

2 The concept of 'company director' in Denmark

2.1 *De iure* directors

Danish company law provides two different governance structures, where the predominant one is the dual-executive system which distinguishes between two levels of executives (directors and managers) and the other distinguishes between supervisors and managers. Thus, it is not straightforward to apply the term 'director' to denote executives as is customary in other jurisdictions. Rather, the following usage will be observed. All persons appointed to a governance organ are termed 'officers'. By 'directors' is meant an officer with executive powers which may include members of a Board of Directors or a Board of Managers, respectively. The distinction between directors and managers is thus only applied when there is a need to distinguish between the two different forms of executives.

Section 112 (1) of the Danish Companies Act imposes general requirements on officers in a public limited company. All officers of a public limited company must have full legal capacity and cannot be under guardianship or the care of a surrogate decision-maker under sections 5 and 7 of the Danish Guardianship Act. Although there are no provisions in the Danish Companies Act which prohibit officers from being bankrupt, officers can be deprived of the right to act as director or manager of a public limited company by judgement pursuant to section 79(2) of the Danish Criminal Act.[13] It can be concluded conversely from section 112 (1) that an officer cannot be a legal person.[14] Moreover, there are no longer Danish residence requirements with regard to officers.

The Danish Companies Act does not impose any further qualification requirements on officers. However, the company's articles of association or special acts may do so.[15] With regard to public listed companies, pursuant to section 2.4.1.1 of the NASDAQ OMX Copenhagen A/S listing rules, the composition of the Board of Directors shall reflect sufficiently the competence and experience required to govern a company whose shares are admitted to trading on a regulated market and to comply with the obligations of such a company.

Section 140 of the Danish Companies Act provides that the employees in companies with an average of at least 35 employees for the preceding three years are entitled to elect representatives and alternate representatives to the Board of Directors or Supervisors, corresponding to half the number of the other management members, i.e. one third of the total. However, the employees always have the right to elect at least two representatives and alternate members. The employees are entitled to elect fewer representatives than the number of representatives specified above where a sufficient number of representatives cannot be elected.[16] The employees of the company, not their unions, are vested with the right of co-determination, and the respective directors must be found among the employees of

[13] The Danish Criminal Act: LBK nr 1062 af 17/11/2011.
[14] Section 112(2) constitutes an exception to section 112(1) with regard to executive officers in public limited shipping companies.
[15] E.g. the Danish Financial Business Act.
[16] The Danish Companies Act, section 140(1).

the company. A survey from the late 1990's found that only one fifth of companies where co-determination was possible actually applied the system.[17] This low usage can be explained by the fact that employees enjoy other rights derived from collective bargaining arrangements, including participation in committees on co-operation and information rights. They may prefer these rights to electing representatives to the Board of Directors, where the employee representatives are subject to the responsibilities of directors, notably the duty to act solely in the company's interests.

Other stakeholders may have the right to appoint directors if provided for in the articles of association, although such rights are very unusual. As the shareholders must appoint at least the majority of the directors or supervisors and as the employees may be entitled to appoint one third of the total number of the directors or supervisors where the rules on co-determination apply, the introduction appointment by a mandate in the articles would enlarge the board considerably. In contrast, Danish companies tend to have rather small boards even in large publicly traded companies.

2.2 Application of the duties to *de facto* and shadow directors

The Danish Companies Act does not distinguish between *de iure*, *de facto* and shadow directors. Section 361(1) of the Act only enumerates promoters and officers when expounding liability with regard to the performance of duties. Nevertheless, it is clarified in the legislative proposal[18] for the Danish Companies Act that the provision also comprises other persons than those who have been officially appointed officers, e.g. shareholders and creditors when they effectively make executive decisions. The legislative proposal emphasises that it is apparent from the case law that the standard for holding a person responsible for a breach of directors' duties without being officially appointed as a director is very demanding.[19] UfR U 2007.497 H is an example of such a case from the jurisprudence of the Danish Supreme Court. Mr. Steffensen was the initiator of the company Calypso Verdensrejser A/S (hereinafter Calypso), which carried out business in the travel industry. As Mr. Steffensen was restricted by a non-competition clause related to his former job as director for a competing company, it was not possible for Mr. Steffensen to join the board himself. The Supreme Court referred to the judgement of the High Court with regard to the assessment of the role of Mr. Steffensen in relation to Calypso. The High Court stated that even though Mr. Steffensen was not officially listed as a shareholder or a director he was the one who in reality managed the company as he decided upon all major matters himself.

[17] Report on active ownership (1999), issued by a number of Danish ministries.
[18] LFF2008-2009.1.170.
[19] The legislative proposal does not refer to any specific case law.

3 THE SCOPE OF DIRECTORS' DUTIES UNDER DANISH LAW

3.1 Types of directors' duties

3.1.1 Duty of care

The concept of fiduciary duties is not known in Danish law to the same extent as in English law. However, a director is subject to a duty of loyalty to place the interests of the company before his own and a duty to act with due care. The duties are based on principles of tort law and agency law, and the resulting standards of loyalty and care are not very different from those applied under English law. Thus, Danish company law operates with fault-based negligence standards when determining directors' liability. This implies that a claimant has to prove, in addition to demonstrating the director's negligence, that a loss has been suffered, that a causal connection exists, and that the damage was foreseeable. It also follows from general principles of Danish tort law that the duties are cumulative.

Section 361(1) of the Danish Companies Act is a codification of the general negligence standard in Danish law. It follows from the provision that promoters and directors who in the performance of their duties have intentionally or negligently caused damage to the public company are liable to pay damages. Furthermore, the latter also applies where damage is caused to shareholders or any third party. Thus, in theory it is possible that a third party may direct his claim directly against a director, but in practice the claim would be directed against the company on whose behalf the director was acting, and it would be an internal matter to make a claim against the director for his actions.

There is no single provision in the Danish Companies Act that enumerates all duties and responsibilities of directors of a public limited company. Rather, these duties are found throughout the Act. Furthermore, the directors' duties and responsibilities can be derived from the company's articles of association, the company's rules of procedure and the Danish corporate governance recommendations. The recommendations propounded by the Danish Committee on Corporate Governance do not directly affect directors' liability, but they may influence the assessment of a breach made by a court in a pending trial to some extent if they have become widely accepted.[20]

3.1.2 Directors' duties and responsibilities – the classic Danish model

The Board of Directors is the central executive body and the directors are jointly responsible for the hiring and firing of the managers.[21] While a director is appointed for a specific term, managers are hired and not appointed, and they may be fired without notice and at discretion. Although their contract may provide for severance pay, a notice period and other entitlements, the effect in company law is immediate.

[20] Mette Neville and Ensig Sørensen, *Den nye selskabslov* (1st supp, 1st edn, Jurist- og økonomforbundets forlag, 2009).
[21] The Danish Companies Act, section 111(1)(1).

In addition to performing the overall duties of directors and taking strategic management decisions, the Board of Directors must ensure the proper organisation of the company's business. The Board of Directors is thus responsible for planning investments, the financing of the company's activities, and devising employment policies. The Board of Managers must follow the instructions of the Board of Directors. It is responsible for carrying out the decisions and instructions of the Board of Directors and filling the gaps left by the directors' decisions.[22] Furthermore, the Board of Managers is responsible for the day-to-day business not including decisions of an unusual nature or of major importance.[23] The latter must be put before the Board of Directors.

Section 115(1) of the Danish Companies Act stipulates that the Board of Directors must ensure that the bookkeeping and financial reporting procedures are satisfactory, having regard to the circumstances of the public limited company. This provision aims at facilitating the internal or external auditing.[24] Section 115(2) of the Danish Companies Act states that the Board of Directors has to ensure that adequate risk management and internal control procedures have been established. Pursuant to this provision the Board is required to define risks related to the company's activities and facilitate devices in order to prevent such risks. Relevant risks include, amongst others, environmental risks, exchange rate risks and political risks.[25] The Danish Committee on Corporate Governance also recommends that the Board of Directors identify the most important business risks and that the Board of Managers report to the Board of Directors or Supervisors on developments within the most important areas of risk and on compliance with adopted policies.[26]

Thirdly, the Board of Directors must ensure that it receives ongoing information as necessary about the public limited company's financial position.[27] Thus, the Board of Directors has to ensure that adequate information procedures are in place. It follows from section 115(4) of the Danish Companies Act that the Board of Directors has to ensure that the Board of Managers performs its duties properly and as directed by the Board of Directors. In order for the Board of Directors to be able to discharge these supervisory functions, it is important that the necessary information procedures are in place. Finally, the Board of Directors has to ensure that financial resources of the limited liability company are adequate at all times, and that the company has sufficient liquidity to meet its current and future liabilities as they fall due.[28] The Board of Directors is therefore required to assess the company's financial position continuously and ensure that the existing capital resources are adequate.

3.1.3 Directors' duties and responsibilities - The two-tier model

Where a public limited company is structured according to the two-tier model, the Board of Managers is responsible for overall, strategic and day-to-day management. Additionally, the Board of Managers must ensure proper organisation of the limited liability company.[29] Therefore, within this model the Board of Supervisors is only responsible for monitoring the Board of Managers. When determining the extent of the Board of Supervisors' monitoring duties, the relevant rules put in place for the Board of Directors, in respect of their obligation to supervise under the classic Danish model, will apply.[30]

[22] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[23] The Danish Companies Act, section 117(1).
[24] Ibid.
[25] Ibid.
[26] Section 8.1, Recommendations on Corporate Governance, August 2011.
[27] The Danish Companies Act, section 115(3).
[28] The Danish Companies Act, section 115(5).
[29] The Danish Companies Act, section 117(2).
[30] The Danish Companies Act, section 116.

3.1.4 Related party transactions

Pursuant to section 131 of the Danish Companies Act, executive officers may not enter into transactions with their company or be involved in legal proceedings against that member. Additionally, they may not participate in a transaction between the limited liability company and a third party, or legal proceedings against a third party, if they have material interest in the business transaction and that material interest may conflict with the interests of the company.[31] A disqualified officer may, however, be present at board meetings where the disqualifying issue is discussed and the board has requested a statement.[32] Thus, Danish law relies on an *ad hoc* approach to conflicts of interest and has traditionally not placed emphasis on the concept of 'independence' as a requirement to serve as officer, as is the case in English law. On the contrary, the concept of independence is difficult to realign with the emphasis on shareholder influence which is visible in the Companies Act, which tends to emphasise accountability to shareholders rather than their independence of them.

An officer is not disqualified by the mere fact that he has a business relationship with the company. In UfR 1966.575 H, the Danish Supreme Court found that a director was not legally disqualified only because he was a member of the Board of Directors and at the same time a purchaser of the company's products. An officer has the right to vote for himself when the board is electing its chairman.

Officers who are also holding shares in the company are not precluded from participating in the board's considerations regarding the board's recommendations to the shareholders on the employment of the company's funds.[33]

Employee-elected directors or supervisors are not disqualified with regard to general employee-related issues, e.g. remuneration. They will, however, be disqualified with regard to specific issues related to actual matters concerning the work force, e.g. industrial action.[34]

Finally, section 131 does not encompass the shareholders of a public limited company.[35]

3.1.5 Corporate opportunities

Danish company law does not formally include a corporate opportunities doctrine. Rather, directors owe a duty of loyalty to the company which may prevent them from taking a corporate opportunity. The doctrine is more relevant in respect of managers, who deal on a day-to-day basis with the company and here the matter is addressed by contract law. Thus, a contract of service between a company and a manager will under normal circumstances include a non-competition clause. A contract of service is usually supplemented by the company's rules of procedure. Furthermore, there are no provisions in Danish company law preventing a shareholder from carrying out business which

[31] The Danish Companies Act, section 131.
[32] Betænkning nr. 1498/2008 p 919.
[33] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[34] Ibid.
[35] Bernhard Gomard and Peer Schaumburg-Müller, *Kapitalselskaber* (6th supp, 1st edn.Jurist- og Økonomforbundets forlag, 2011).

is in competition with the company. However, it is very common in closely held companies to include a non-competition clause in the shareholders' agreement.[36]

3.2 To whom are the duties owed?

The Danish Companies Act does not provide a clear view of the extent to which stakeholders' interests are to be integral to the operation of the company. There is, however, no basis for assuming that the Danish Companies Act in general takes stakeholders into consideration apart from the provisions in the Act where these are explicitly mentioned, e.g. employee-elected officers, rights of minority shareholders etc.[37]

The general meeting can give the Board of Directors or Supervisors specific instructions.[38] This reflects the doctrine of 'active ownership', that is, that the ultimate decision makers should be the shareholders. The Companies Act makes such influence possible and the prevalence of dominant shareholders ensures that these powers are in fact exercised. Thus, even outside the general meeting the Board will be keen to engage regularly with dominant shareholders to ensure that they approve of the overall strategy pursued. Danish securities law accepts the selective disclosure of inside information to dominant shareholders in publicly traded companies where it is necessary for them to perform their role of active owners, although possession of inside information will of course prevent them from trading and obliges them to keep the inside information confidential.

3.3 The director as a shareholder

An officer who holds shares in the company is not bound by directors' duties when he is exercising his shareholder rights at the general meeting. According to section 108, the general meeting may not pass a resolution if it is clear that the resolution is likely to give certain shareholders or other parties an undue advantage over other shareholders or the public limited company. A resolution passed in breach of section 108 may lead to nullity or to compulsory dissolution of the company by the court.[39]

Section 127(1) of the Act is said to extend section 108 as it states that officers may not enter into a transaction that is clearly capable of providing certain shareholders or others with an undue advantage over other shareholders or the company.[40] Furthermore, it follows from section 127(1) that officers must not comply with any resolution passed by the general meeting or any other governing body if that resolution is invalid or in contravention of the law or the company's articles of association.

3.4 The time span of the duties

The officers appointed by the general meeting hold office for the period specified in the company's articles of association, usually with the requirement of annual re-appointment. The members' term of

[36] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[37] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[38] Ibid.
[39] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[40] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).

office expires with the closing of the annual general meeting and cannot exceed four years from their election.[41] Even where the articles allow a director to serve for a period of up to the maximum of four years, whoever appointed the officer may at any time dismiss him and appoint a replacement. Consequently, shareholders can always call a new general meeting and replace one or more of the directors at their discretion. Thus, there are no staggered boards in Danish companies, a fact that again underlines the influence of shareholders on the management. The usual term is one year to expire at the next annual general meeting, but as re-appointment is customary, the term may well be viewed as continuing indefinitely until terminated at a general meeting.

Officers may resign at any time. Notice of resignation must be given to the Board where they serve and, if a member has not been elected by the general meeting, also to the appointing party. Officers may be removed at any time by the electing or appointing party.[42] If the Board, after receiving a director's notice of resignation, does not notify the Danish Business Authority, the officer is entitled to give this notification himself. In general, however, an officer is perceived as having retired from the Board from the time the officer gives the Board notice of his resignation.[43] The latter might be of importance in relation to determining whether the officer is in breach of his duties. Thus, an issue is whether an officer can avoid liability if the pertinent member regards the acting of the board's majority as being reckless.

There are several ways in which an officer can signify his disapproval of a matter. Firstly, a dissenting member of a board is entitled to have his opinion entered in the records of the board meeting.[44] Furthermore, a disapproving officer can decide to resign from his position as described above.

Although an officer will mostly not be liable for damages after his resignation,[45] it is unclear under what circumstances the officer will be able to avoid liability, as this depends upon the degree of the exercised recklessness.[46] In some cases the officer has to notify the shareholders in addition to notifying the Board of Directors or Supervisors.[47] In UfR 1997.283 H the Danish Supreme Court found a chairman liable to pay damages to a company's bankrupt estate as he had resigned without notifying the shareholders. The court held that the chairman should have realised, based on the information available, that it was likely that the only remaining director would abuse his position to act on behalf of the company, thus, causing the company a loss. In UfR 2004.2253 H the court found a director liable according to the statutory provisions in the Companies Act on officer liability to pay damages to the creditors of a company for loss caused even after his resignation. The court did not make a distinction between the officers who had resigned and those who had not resigned in UfR 1940.563 Ø. The lack of distinction was arguably caused by the fact that the material negligence was conducted while all the officers were still members of the board.[48]

[41] The Danish Companies Act, section 120(4).
[42] The Danish Companies Act, section 121(1).
[43] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[44] The Danish Companies Act, section 128(2).
[45] See U 1921 727 H and U 1930 864 Ø.
[46] Mette Neville and Karsten Engsig Sørensen (red.), *Den nye selskabslov,* (1st supp, 1st edn., Jurist- og Økonomforbundets Forlag, 2009).
[47] Ibid.
[48] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).

4 LIABILITY FOR BREACH OF DUTY

4.1 Duty of care: conditions for liability

The basic principle of non-contractual liability within Danish tort law is negligence, thus, this principle is applied with regard to directors' liability for breach of their duties. A director will therefore be liable for damages where the claimant has suffered a loss, causation is present, the damage was foreseeable, and the director may be said to have acted negligently. The preconditions for incurring liability will be discussed in further detail below.

4.1.1 Improper conduct and burden of proof

When assessing whether a director is in breach of his fiduciary duties the director's conduct will be examined in light of the applicable statutes, statutory instruments, and norms of conduct, e.g. the Danish Companies Act, the Corporate Governance Code, and the company's rules of procedure. In Danish tort low the onus of proof is on the claimant. A breach of duty can consist in an unlawful act as well as an omission to act. The latter might, for example, be relevant in relation to the Board of Directors or Supervisors' duty to monitor the Board of Managers.

4.1.2 Causation

Although causation is a prerequisite for liability under Danish tort law, in more recent cases courts have arguably been inclined to reduce the requirements of proving causation in relation to gross contraventions.[49] In UfR 2000.2176 H, the Danish Supreme Court found a bank, BG Bank A/S, to be liable for erroneous information in a stock exchange announcement regarding an issue of shares. The Company Commercial Holding International A/S (hereinafter Commercial Holding) was founded in 1989 as a holding company of a financial services group. In November 1989 the share capital was issued through BG Bank A/S and by the end of the subscription period on 31st January 1990 only DKK 9.7 million of DKK 22.1 million of the nominal share capital had been subscribed for. Therefore, the Board of Directors of Commercial Holding entered into an agreement with BG Bank A/S whereby the board subscribed for the remaining shares by means of a company founded for that purpose. Subsequently, BG Bank A/S announced on 1 February 1990 that the shares issue was oversubscribed. The Danish Supreme Court held that the stock exchange announcement had been evidently erroneous and that BG Bank A/S had intentionally misled the market to further its own interest, thus affecting the share price. BG Bank A/S was therefore found liable in damages for the loss caused by the misleading stock exchange announcement. It was not clear how the individual investors would have acted if the information in the announcement had been correct; however, the court found that BG Bank A/S should not benefit from the uncertainties with regard to causation. In contrast, in UfR 2000.585 H, the Danish Supreme Court found that the stock exchange announcement was only of minor importance and, hence, causation was required.

[49] Ibid.

Additionally, it is a precondition for liability that the damage is foreseeable. A person is not liable for his negligent act if the damage is atypical and arbitrary in relation to the generated risk.[50] The foreseeability can be illustrated by the following example from Danish case law. In U.1955.1050V, a factory worker, Mr. Godballe, threw a partly eaten apple at a colleague while working in a workshop. A colleague, Mr. Lorentzen, who was standing approximately seven meters away from Mr. Godballe, was hit on the back of his head by the apple. Mr. Lorentzen had previously in his life suffered from neurosis. Because of the accident his condition deteriorated and he was unable to work for long periods of time. Even though it was presumed that the illness of Mr. Lorentzen was triggered by the accident, the court found that the damage caused had not been foreseeable by Mr. Godballe. This case illustrates how it is possible for causation to be present without the damage caused being foreseeable by the tortfeasor.

4.1.3 Standard of care

Finally, a director must have acted negligently in order to incur liability for breach of duty. In Danish law, a simple negligence standard applies to the members of management. As mentioned above, section 361(1) of the Danish Companies Act codifies the negligence standard. It follows from the provision that promoters and members of management who, in the performance of their duties, have intentionally or negligently caused damage to the company are liable to pay damages. The standard of care is largely objective, but professional knowledge or qualifications of the respective director may lead to a heightened standard.

The legislator chose to deviate from the general simple negligence standard in relation to shareholders. Pursuant to section 362 of the Danish Companies Act, shareholders must provide compensation for any losses that they cause to the company, other shareholders or third parties through intentional acts or omissions, or gross negligence.

Danish case law defines the negligence standard applicable to members of the management in greater detail. The case law pre-dates the recent legislative introduction of the two-tier model and is more related to the classic Danish governance structure consisting of a Board of Directors and a Board of Managers. However, the case law is also instructive for purposes of delineating the liability of the members of the Board of Supervisors and the Board of Managers in the two-tier model. Although the duties are placed with different bodies in comparison with the classic Danish model, the scope and content of the duties and responsibilities remain the same. Thus, the case law regarding the Board of Directors' monitoring duties may be of relevance when assessing potential breaches by members of the Board of Supervisors. Equally, case law concerning the directors' management duties is relevant when assessing the responsibility of the members of the Board of Managers in a two-tier board structure.[51]

In general, the same negligence standard applies to all members of the Board of Directors or Supervisors, including employee-elected board members and non-professional members. Although the Danish courts have chosen not to adjust the negligence standard with respect to specific groups,

[50] Bo Von Eyben and Helle Isager (7th supp, 1st edd, Jurist- og Økonomiforbundets Forlag, 2011).
[51] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).

section 363(1) of the Danish Companies Act allows for reduction in compensation and damages awarded. The Act states that damages and compensation may be reduced if it is considered reasonable having regard to the degree of fault, the amount of the loss and other circumstances of the case.

In UfR 2001.878 H, the Danish Supreme Court reduced the amount of payable damages in relation to a family member who was also a member of the Board of Directors. Likewise, the Court reduced the amount of damages in UfR 1979.777 V where three family members sitting on the Board of Directors were found liable for damages as the board had approved an illegal shareholder loan, probably because their influence on the decision had been minimal. Thus, although a Board may make decisions as a collective, the liability of its members is decided individually. In addition, the degree of negligence is likely to influence a court's assessment of the case. In UfR U 2007.497 H (mentioned above), the Supreme Court refused to reduce the damages payable by a family member who was found to be liable. Mr. Kurt Steffensen was the initiator of the company Calypso Verdensrejser A/S (hereinafter Calypso), which carried out business in the travel industry. As Mr. Kurt Steffensen was restricted by a non-competition clause related to his former job as a director for a competing company, it was not possible for him to join the board himself. Mr. Søren Steffensen was the father of Mr. Kurt Steffensen, and at the time he joined the board he was 72 years old. Mr. Søren Steffensen, a retired semi-skilled worker, accepted to join the board without taking into consideration the responsibilities and duties this would imply. He signed documents whenever he was asked to do so, and he visited the company which was located in Copenhagen once. Apart from this, he had no contact with either the company or his son. His acts were held to constitute gross negligence, which led the Court to refuse a reduction in payable damages.[52]

Even though the Danish Companies Act does not contain any minimum requirement regarding the directors' qualifications, it is presumed that members of management should be aware of the duties and responsibilities laid down in the Danish Companies Act and the Financial Statements Act.[53] Moreover, basic knowledge of business affairs is also a requirement.[54] In general, it does not affect the assessment of a potential breach if a director does not receive remuneration for his work.[55] On the other hand, Danish courts take some subjective elements into consideration when examining the required standard of care. A director will be assessed more strictly if the relevant breach is related to a field in which he holds professional qualifications.[56]

4.1.4 The business judgement rule

Danish courts have developed a presumption similar to the American Business Judgement Rule. Members of management are in general not liable for business decisions which turn out to be disadvantageous for the company. Under certain circumstances, the Danish courts only apply a limited review of business decisions of management. The rationale behind this approach is equivalent to the one in American law: Directors are perceived to be better placed to make business decisions than the courts. As a precondition for the presumption to apply the directors must have apprised themselves of all material information reasonably available prior to taking an informed business

[52] Ole Borch and Torben Vistisen, *30 år efter Havemann* [2007] Erhvervsjuridisk Tidsskrift 237.
[53] The Danish Financial Statements Act: LBK nr 323 af 11/04/2011.
[54] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[55] Ibid.
[56] Ibid.

decision. Members of management will likewise not be protected if they have displayed disloyal conduct.[57]

The AOF case, reported in UfR 2006.2637 H, confirmed the existence of an approach similar to the American Business Judgement Rule in Danish law.[58] Arbejdernes Oplysningsforbund - Århus (hereinafter AOF) carried out business in the educational industry. For years the company had negative returns, which is why the Board of Directors continuously dealt with the economic state of the company at board meetings. In spite of the continuing negative returns the Board of Directors expected that the economic state of the company would change and the company would return to profit. Finally, after several years with negative returns the Board of Directors filed a petition in bankruptcy. The Supreme Court found that the Board of Directors had exercised due care. A crucial factor for the outcome of the judgement appears to have been that the Board of Directors had consulted with persons with expert knowledge on a regular basis.[59]

UfR U 2007.497 H (mentioned above) illustrates the existence of a minimum level of care that directors have to display when taking business decisions. In this case the directors did not hold any board meetings and did not prepare any interim statements or accounts. Moreover, no budget follow-up was prepared. On these grounds, all members of the Board of Directors were found liable under section 54(3) of the former Danish Companies Act (Aktieselskabsloven).[60]

In U 2006.243 H, the Danish Supreme Court considered the limits of the Board of Directors' discretion when taking business decisions. The Supreme Court disagreed with the board's assessment that there was a possibility that the company would survive. The Court held that the discretion was exercised without any professional basis and that the decision was reckless. It argued that the members of the board ought to have known that the company had no reasonable prospect of not entering insolvency. This case shows that the Board of Directors is not always free from responsibility as long as they have exercised discretion. However, the burden of proof is shifted and the claimant has to show that the directors exercised their discretion recklessly.[61]

4.1.5 Delegation

If any body of the company exceeds the competences entrusted to that particular body, the members of the relevant board might be liable under section 361 of the Danish Companies Act if they act negligently.[62]

It is presumed that delegation of the day-to-day management, for example to a management company, is possible, though it is highly unusual. The board will still bear the ultimate responsibility and must ensure that the agent is competent and the agreement entered into is reasonable, e.g. that it contains a reasonable termination of contract clause. Likewise, delegation of the Board of Directors' duties is supposedly possible, even with regard to material and major decisions. However, the Board

[57] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[58] In 1977, the Danish Supreme Court gave a judgement in favour of the Board of Directors to be liable based on an approach similar to the business judgement rule: U 1977.477H.
[59] Ole Borch and Torben Vistisen, *30 år efter Havemann* [2007] Erhvervsjuridisk Tidsskrift 237.
[60] Equivalent to section 115 of the Danish Companies Act of 2011.
[61] Ole Borch and Torben Vistisen, *30 år efter Havemann* [2007] Erhvervsjuridisk Tidsskrift 237.
[62] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).

of Directors is required under the Danish Companies Act to monitor the party to whom responsibility is delegated.[63] The standard of care would be the same, but as delegation is highly unusual, there is no case law to substantiate this.

4.2 Insurance against liability

There is no provision in the Danish Companies Act that deals with insurance. However, it is very common for Danish companies to purchase directors' and officers' liability insurance for members of management against liability for simple negligence. Gross negligence is usually not covered by the insurance policy. As long as the cost of the insurance paid by the company is reasonable such insurance is not seen as an issue.[64]

4.3 Consequences of liability

The liability for officers is individual. This means that the Board of Directors as a collective body is in general not liable although, for example, individual members of an audit committee are in breach of their fiduciary duties. In general, an officer is not liable for decisions taken at board meetings where he was not present due to illness or other excusable circumstances. However, the board member is obliged to attempt changing a culpable decision taken by the board in his absence. Furthermore, passivity does not discharge responsibility.[65]

The Board of Directors or Supervisors must monitor the Board of Managers and the company as a whole.[66] In UfR 2007.497 H (mentioned above), the Board of Directors was found liable for damages as it had not adequately monitored the Board of Managers and the economic state of the company.

If multiple persons are liable, they will be jointly and severally liable for damages. The payable amount for each individual director will be determined at the discretion of the court taking into consideration negligence and other relevant facts. However, any person whose liability has been reduced is only liable for the reduced amount.[67]

[63] Ibid.
[64] Ibid.
[65] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[66] The Danish Companies Act, section 215.
[67] The Danish Companies Act, section 363(2).

4.4 Exemptions and limitations

The normal limitation period for claims regarding non-contractual liability is ten years under section 3(3)(2) of the Danish Limitation Act of 2007.[68] The Danish Companies Act contains a special provision with regard to the granting of discharge by the general meeting. Legal action (by the shareholders) pursuant to section 365 must be taken no later than six months after the date of the resolution that granted exemption from liability or waived the right to take legal action. Furthermore, legal action must be taken no later than three months after the date of the company being declared bankrupt. It is not possible to limit officers' liability by provisions in the Articles. The general meeting may pass a resolution to absolve the Board of Directors or Supervisors of any liability, but it would only cover matters that had been properly disclosed to the general meeting at the time of the resolution.

[68] The Danish limitation Act: LOV nr 522 af 06/06/2007.

5 Duties in the vicinity of insolvency

5.1 Change of existing duties

While not expressly mentioned in the Danish Companies Act, the interests of the company change in the vicinity of insolvency. The duty of officers then shifts from protecting the interests of the shareholders to protecting creditor interests.[69] Case law has established that officers who knew or ought to have known that the company had no reasonable prospect of not entering insolvency and did not take every step to minimise potential losses to creditors is liable for the losses suffered. In U 2006.243 H, a member of the Board of Directors was held to be liable to the bankruptcy estate.[70] The Supreme Court found that the director ought to have known that the continuation of the activities of the foundation was only warranted if it was ensured that no more debt was incurred, existing debt was reduced, and the purchase of goods was carried out by cash payment only. Thus, although the Danish Bankruptcy Act does not contain rules on "wrongful trading", such transactions fall within the scope of section 361(1) of the Companies Act and are, accordingly, unlawful.

5.2 Newly arising duties

A public limited company will cease to exist under the following circumstances: dissolution by declaration, resolution to enter into liquidation, or transition into bankruptcy.[71] The Danish Companies Act contains rules on voluntary liquidation whereas the rules on bankruptcy are contained in the Danish Bankruptcy Act. Additionally, the Bankruptcy Act also governs restructuring of the company.

Pursuant to section 233(1), only the Board of Directors, the Board of Managers (in a two-tier structure) or, if the company is in liquidation, the liquidator may file a petition in bankruptcy on behalf of the company.[72] The primary condition for bankruptcy is insolvency of the debtor. Insolvency is defined in section 17(2) of the Danish Bankruptcy Act, which states that a debtor is insolvent "when he is incapable of paying his debts as they fall due unless such inability may be deemed to be of a temporary character only."[73]

[69] Lars Bunch and Jan Schans Christensen, *Selskabets egeninteresse - navnlig set i lyset af selskabslovens generalklausuler* [2011] U.2011B.1.
[70] The Supreme Court decision concerned a foundation, however, the judgement is likewise applicable in relation to public limited companies, see Lars Bunch and Jan Schans Christensen, *Selskabets egeninteresse - navnlig set i lyset af selskabslovens generalklausuler* [2011] U.2011B.1, p 2.
[71] The Danish Companies Act, sections 216, 217, 233.
[72] Thus, a Board of Supervisors may not file a petition in bankruptcy on behalf of the company.
[73] Bent Iversen et al, *The Danish Business Law* (4th edn, DJØF Publishing, 2010) 491.

5.2.1 Loss of capital

Public limited companies must have a minimum share capital corresponding to DKK 500,000, and a private limited company must have DKK 80,000.[74] If it is established that the equity of a company represents less than half of the subscribed capital or comes below DKK 67,500, the management of the company must ensure that a general meeting is held within six months. At the general meeting, the executive board must give a report on the financial position of the company and, if necessary, submit a proposal for measures that should be taken, including a proposal for dissolution of the limited liability company.[75] The officers are obliged to ensure that the financial resources of the limited liability company are adequate at all times. The duty to summon a general meeting arises when the executive officers ascertain the loss of capital.[76]

The Danish Companies Act does not contain any rules on the consequences of the loss apart from the duty to summon a general meeting. Thus, there exists no obligation to enter into liquidation even though the subscribed capital or parts thereof are lost. In some situations the directors will continue the operations of the company without a restructuring if, for example, it can be expected that the continuation of the business activities will re-establish the capital. In other situations, e.g. where a company is part of a group, the management may continue business operations because the main creditor is the parent company, which has signed a letter of subordination.[77]

In general, the failure to summon a general meeting or initiate other necessary actions will affect the negligence assessment when determining if the individual director is in breach of his duties. Furthermore, it may give rise to criminal liability.[78]

The rules on avoidance are set forth in chapter 8 of the Danish Insolvency Act. According to these rules a transaction may be set aside, i.e. the bankruptcy estate may disregard the transaction, if the directors have given preference to some creditors at the expense of other creditors. Thus, the directors can, depending on the circumstances, be liable for damages if a transaction fraudulently prefers one creditor at the cost of others.[79]

[74] The Danish Companies Act, section 4(2).
[75] The Danish Companies Act, section 119.
[76] The Danish Companies Act, sections 215(5), 116(5), 118(2).
[77] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[78] Bernhard Gomard and Peer Schaumburg-Müller, *Kapitalselskaber* (6th supp, 1st edn.Jurist- og Økonomforbundets forlag, 2011).
[79] Ibid.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue

6.1.1 The company as plaintiff

Although an individual shareholder is affected indirectly when the company in which he is holding shares suffers a loss, the shareholder may generally not bring a personal action against the tortfeasor, e.g. an officer.[80] The company itself has to bring the legal action if it has suffered a loss. This also implies that potential damages resulting from a finding in favour of the company are to be received by the company. Pursuant to section 364(1) of the Danish Companies Act, any resolution that the public limited company should take legal action against its promoters, members of management, shareholders etc. must be passed by the general meeting.

In Denmark it is not uncommon that the shareholders at the general meeting discharge directors from their obligations with respect to the annual accounts. This does not, however, deprive the company of its right to take legal action if the information which was provided to the general meeting before the resolution was passed was not essentially correct or complete. Derivative action on behalf of the company is possible by minority shareholders who represent more than ten per cent of the subscribed capital and opposed the resolution to discharge.[81]

6.1.2 The shareholders as plaintiffs

6.1.2.1 In their own name

Another exception from the general above-mentioned principle is the situation where the shareholder has suffered a loss, but the company has not. An example of the latter would be a shareholder who has bought shares in the market in reliance on a stock exchange announcement. If it is later discovered that the announcement contained incorrect information the shareholder may have bought the shares at a price that was too high, resulting in a loss for the individual shareholder, but not necessarily for the other shareholders of the company. Under such circumstances the shareholder is entitled to bring legal action in his own name.[82]

6.1.2.2 In the name of the company ('derivative action')

Section 364(3) of the Danish Companies Act permits under certain circumstances derivative suits. Pursuant to the provision, shareholders who represent no less than one-tenth of the share capital and oppose the resolution to grant exemption from liability or waive the right to take legal action can commence legal proceedings to recover damages *for* the company from the person(s) liable for the

[80] See UfR 2005.1577 H.
[81] The Danish Companies Act, section 364(1).
[82] Ibid.

loss suffered. Legal action must be taken no later than six months after the date of the resolution.[83] Section 364(3) is, however, not very advantageous for the shareholder. If a legal action results in a finding in favour of the shareholder the company will receive the damages.[84] This is probably the reason why it is not invoked often in practice.

Finally, a shareholder can possibly bring a legal action against members of management and other persons on behalf of the company for loss suffered by the company if the company does not wish to bring a legal action.[85] This has not yet been settled in case law, but the majority of Danish scholars believe that such an action exists.[86] Thus, the company has priority over individual shareholders in enforcing breaches of duty. The shareholders will generally be bound by a judgement obtained by the company.[87]

6.2 Criminal and administrative sanctions

Chapter 23 of the Danish Companies Act and chapter 24 of the Danish Financial Statements Act contain provisions that sanction breaches of the two Acts. The penalty provisions in the Companies Act and the Financial Statements Act are supplemented by provisions in the Danish Criminal Act.[88] The provisions of the Criminal Act are applicable in relation to gross infringements of the Companies Act. Although the provisions of the Danish Companies Act apply primarily to natural persons, one provision is applicable to legal persons.[89] Pursuant to section 25 of the Danish Criminal Act a company may be punished by a fine, provided such punishment is provided for by law or by regulations issued pursuant to law. However, in order for section 25 to be applicable it is required that acts or omissions can be attributed to directors or employees of the company.

As mentioned above, pursuant to section 79(2) of the Danish Criminal Act, directors can be deprived of the right to act as director or manager of public limited companies by court decision.

[83] The Danish Companies Act, section 365(1).
[84] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[85] Bernhard Gomard and Peer Schaumburg-Müller, *Kapitalselskaber* (6th supp, 1st edn.Jurist- og Økonomforbundets forlag, 2011).
[86] Stinne Taiger Ivø, *Selskabsstattuttet* (1st supp, 1st edn, Karnov Group, 2011) p 223.
[87] UfR 1925.876 H.
[88] Sections 279, 280, 283, 296, 302.
[89] The Danish Companies Act, section 369.

7 CONFLICT OF LAWS

7.1 Classification under Denmark's private international law

7.1.1 Company law

As of 17 December 2009, the Rome I Regulation has replaced the Rome Convention as the applicable set of rules for the resolution of conflicts of contract laws in all EU Member States except Denmark. Denmark has instead relied on a set of separate 'parallel agreements' entered into on an inter-state level. Pursuant to article 1(2)(e) of the Rome Convention, the Convention is not applicable in relation to questions governed by the law of companies or the winding-up of companies. The Rome II Regulation is likewise inapplicable under Danish law due to the Danish reservations.

Under Danish law, conflicts of laws relating to companies are decided by reference to the law applicable at the company's place of incorporation.[90] Hence, the law of incorporation of the company determines its nationality. This means that the provisions of the Danish Companies Act apply only to companies incorporated in Denmark, whilst foreign companies are regarded as being governed by the laws in their places of incorporation, irrespective of where the company's operations are in reality based.[91]

7.1.2 Tort law

In relation to private international tort law the determining factor in Danish law is the principle *lex loci delicti*. Pursuant to this principle, the law to be applied is the law of the place where the tort was committed. Accordingly, this rule may result in the application of the law at the place where the management has its office, where the members of management are domiciled or where a specific decision was taken (the decision which caused the loss).[92] Where a tort arises from actions of a company pursuant to decisions made by its directors, there would be no practical distinction between tort law and company law and hence no difference in the application of international private law.

7.1.3 Special duties in the vicinity of insolvency

The EU Insolvency Regulation is not applicable under Danish law with regard to bankruptcy proceedings initiated in a Danish bankruptcy court. This is due to the four Danish reservations towards the EU. Instead, the Danish Bankruptcy Act (Konkursloven) applies and the appropriate Danish authority is the bailiffs court (skiftretten).

[90] Stinne Taiger Ivø, *Selskabsstattuttet* (1st supp, 1st edn, Karnov Group, 2011).
[91] Jan Schans Christensen, *Kapitalselskaer* (3rd supp, 1st edn, Thomson Reuters Professional A/S, 2009).
[92] Stinne Taiger Ivø, *Selskabsstattuttet* (1st supp, 1st edn, Karnov Group, 2011).

With regard to private international insolvency law, the determining factor pursuant to Danish law is the place where the company carries out its business.[93] Thus, this principle operates independently of the rules on private international company law. Section 3 of the Danish Bankruptcy Act determines the jurisdiction of the bankruptcy court as the place where the company carries out its business. If the company carries out its business in Denmark the competent bankruptcy court is the court where the company has its registered office.[94]

Danish company law governs all actions by a company's directors, also where the company is in the vicinity of insolvency, thus, what would qualify as wrongful trading is not a part of Danish insolvency law, but is governed by Danish company law.

7.2 Application of the relevant private international law rule

7.2 1 Liability of directors outside insolvency

The liability of members of management to the company will in general be determined pursuant to the law applicable to the company, see, e.g. UfR 1998.1071 Ø (Danish High Court decision).[95] In UfR 1998.1071 Ø, the Danish High Court (Østre Landsret) held that a director's liability for damages was to be determined pursuant to the law in Gibraltar as this was the place of the company's registered office. Thus, it is the perception that the latter decision adopts the incorporation theory: the registered seat of the company is the determining factor with regard to the liability of management.[96] The same applies to derivative actions pursuant to section 364(3) of the Danish Companies Act. Whether minority shareholders can rely on the provision depends on the company's place of incorporation.[97]

Where an individual shareholder has suffered a loss, the shareholder can presumably bring an action against members of management pursuant to general tort principles.[98] In such a case, the determining factor will most likely be the registered seat of the company, as the company is the common denominator for the parties.[99]

The qualification of *de facto* directors under private international law is not clear. The sparse Danish case law and theory appear to support the incorporation theory, i.e. the registered seat of the company is the determining factor.[100]

7.2.2 Insolvency

As mentioned above, the Danish Bankruptcy Act and Companies Act do not contain specific rules on "wrongful trading" but applies a uniform standard of liability and consequently wrongful trading falls within the scope of section 361(1) of the Companies Act and is hence unlawful. As a result of the recourse to a mechanism of company law, the incorporation theory applies to cross-border cases.

[93] Ibid.
[94] The Danish Bankruptcy Act, section 3(1).
[95] Ibid.
[96] Stinne Taiger Ivø, *Selskabsstattuttet* (1st supp, 1st edn, Karnov Group, 2011); the same perception is established in English law, see: C.M.V Clarkson and Hill, Jonathan, *The Conflict of Laws* (3rd edn, Oxford University Press, Oxford, 2006) p 246.
[97] Stinne Taiger Ivø, *Selskabsstattuttet* (1st supp, 1st edn, Karnov Group, 2011).
[98] Ibid.
[99] Stinne Taiger Ivø, *Selskabsstattuttet* (1st supp, 1st edn, Karnov Group, 2011).
[100] Ibid.

On the other hand, avoidance of transactions is governed by insolvency law; accordingly, the determining factor is the place where the company carries out its business.[101]

[101] Ibid.

Directors’ Duties and Liability in Estonia

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Contents

1 INTRODUCTION

1.1 Corporate law and director's duties in Estonia

1.1.1 Legislative approach: statute/case law

Estonia has a legal framework in place in the area of director's duties and liabilities. The Estonian legal system uses a combination of standards and rules defining director's duties and liabilities, thus both statutes and case law are relevant. Although the duties of the directors are mainly provided in legislative statutes, many of them require compliance with some standard (*duty of loyalty, duty of care, standard of reasonableness)* and eventually the judge must interpret the standard, determine the facts and decide whether the director's actions were acceptable under such standard. In addition to legislative statutes the director's duties may derive from articles of association, contract, corporate governance code, also from decision of supervisory organ or general meeting.

The precise and clear regulation of directing bodies' duties is important first and foremost from the perspective of a director's personal liability. To be able to demand the fulfilment of the duty, the duty must have predetermined content. Only then is it possible to evaluate whether the duty has been fulfilled appropriately and the extent of the damage has been caused (that is, what sort of consequences could have been avoided by the appropriate fulfilment of duties). However, most of the directing bodies' duties and their fulfilment qualities are characterised by abstract and imprecisely defined legal concepts[1].

Nevertheless, there are some duties of directors that are regulated by very specific statutory rules (*obligation to file for bankruptcy, obligation to organise accounting)*. All directors' duties are analysed in-depth further in the report.

1.1.2 What role does the market practice play in the assessment of director conduct?

The director is always expected to exercise duty of care while performing his/her tasks. In order to evaluate whether the duty of care has been exercised properly, one must also consider relevant practice. Therefore it is likely that different business areas require a different standard of duty of care. The required level of duty of care depends on the specialty and operating range of the company. That is, the wider the operating range and the more complicated the area of activity is, the stricter the requirements of the director are[2].

According to § 24 of Law of Obligations Act if a party is obligated to do all that is reasonably possible to achieve a result, the party is obligated to make such efforts as reasonable persons in the same field of activity or profession would make under the same circumstances.

[1] Tuuve Tiivel, „Äriühingu juhtorgani liikme hoolsuskohustus“ Juridica IX/2005 621
[2] *Ibid.* 624

The abovementioned principle also applies when assessing the fulfilment of directors' duties. The level of care, ordinarily expected from a director when performing his/her tasks, must be equal to the care that any other reasonable person in the same position under the same circumstances would implement. Thus, all the aspects related to legal relationship between the director and the company must be taken into consideration when evaluating the fulfilment of duty of care, including the company's general purpose and area of activity, type and size, characteristics of the task, but also the relevant practice[3].

The General Part of Civil Code Act § 2 mentions custom as one source of civil law. Custom arises from long-term usage of a type of conduct if the persons involved in commerce consider it legally binding. A custom shall not change the law.

1.1.3 Where and how are directors' duties addressed?

The areas of law that regulate companies are general private law, company law, law of obligations (including tort law) and criminal law (mainly crimes connected with companies that may be committed by the director). The legal entity's director's duties and liability are covered in the following legal acts (listed from *lex generalis* to *leges speciales*):

- General Part of the Civil Code Act 2002 (official gazette RT I 2002, 35, 216; 06.12.2010, 1; in Estonian *Tsiviilseadustiku üldosa seadus*, abbreviation TsÜS): contains general principles regarding legal persons, including governing body members' general duties and liability; *bona fide* principle; obligation to file for bankruptcy etc. Estonian TsÜS chapter about legal entities is mainly based on relevant regulation in Dutch Civil Code (*Burgerlijk Wetboek*)[4];

- Commercial Code 1995 (official gazette RT I 1995, 26. 355; 28.12.2011, 50; in Estonian *Äriseadustik*, abbreviation ÄS): contains specific rules for different types of companies[5], including provisions repeating in more detail general private law principles provided in TsÜS (regulation of director's duties and liability, obligation to file for bankruptcy etc);

- Non-profit Associations Act 1996 (official gazette RT I 1996, 42, 811; RT I, 14.03.2011, 8; in Estonian *Mittetulundusühingute seadus,* abbreviation MTÜS): contains specific rules for non-profit associations, including regulation of director's duties and liability;

- Foundations Act 1996 (official gazette RT I 1995, 92, 1604; 17.12.2010, 28; in Estonian *Sihtasutuste seadus,* abbreviation SAS): contains specific rules for foundations, including regulation of director's duties and liability;

- Commercial Co-operatives Act 2002 (official gazette RT I 2002, 3, 6; in Estonian *Tulundusühistuseadus,* abbreviation TÜS): contains specific rules for commercial co-operatives, including regulations of director's duties and liability; also provisions of

[3] Paul Varul, Irene Kull, Villu Kõve, Martin Käerdi, *Tsiviilseadustiku üldosa seadus. Kommenteeritud väljaanne* (Kirjastus Juura Tallinn 2010) 129
[4] *Ibid.* 79
[5] Commercial code regulates the following types of companies: general partnership (*täisühing*), limited partnership (*usaldusühing*), private limited company (*osaühing*), public limited company (*aktsiaselts*) or commercial association (*tulundusühistu*)

Commercial Code regarding private limited company apply if not stated otherwise in TÜS[6];

- Bankruptcy Act 2004 (official gazette RT I 2003, 17, 95; 29.06.2011, 14; in Estonian *Pankrotiseadus*, abbreviation PankrS): contains rules for insolvency proceedings, including relevant regulations of the company director's duties and liability (for example liability in case of grave error in management);

- Reorganization Act 2008 (official gazette RT I 2008, 53, 296; in Estonian *Saneerimisseadus*, abbreviation SanS): contains rules for reorganization of legal person governed by private law, including regulations of the company director's duties and liability (for example non-limitation of liability for not filing for bankruptcy during reorganization);

- Law of Obligations Act 2002 (official gazette RT I 2001, 81,487; 08.07.2011, 21; in Estonian *Võlaõigusseadus*, abbreviation VÕS): contains provisions defining general contractual obligations of directors (on the basis of an agreement similar to authorization agreement); rules regarding contractual and non-contractual liability (tort), applicable to directors in case of breach of their duties or if damage is caused to shareholder or third party; and

- Penal Code 2002 (official gazette RT I 2001, 61, 364; 29.12.2011, 190; in Estonian *Karistusseadustik*, abbreviation KarS): contains rules prescribing criminal liability for certain breaches of director's duties (for example criminal liability in case of failure to file for bankruptcy in time or to call for shareholders meeting; also if causing the company's insolvency and similar).

All abovementioned grounds for director's liability are analysed in-depth further in the report.

Also, the Estonian Parliament has adopted laws to implement Council Regulations regarding European Company, Cooperative Society and Economic Interest Grouping[7].

1.2 Corporate landscape in Estonia

1.2.1 Private/public companies

The general principles for the regulation of legal persons are provided in the General Part of the Civil Code Act. The provisions in the General Part of the Civil Code Act about general duties and liability of members of a directing body of legal person apply both for legal persons in private law and legal persons in public law (in the latter case, unless provided otherwise in an act pursuant to what the legal person in public law was established). In most cases the duties of a legal person in public law are

[6] Considering the scope of current study with focus on public companies, the Non-Profit Associations Act, Foundations Act and Commercial Associations Act are not relevant, but are mentioned here for the purpose of clarity.
[7] Council regulation (EC) No 2157/2001 on the Statute for a European company [2001] OJ L294/1; Council regulation (EC) No 1435/2003 on the Statute for a European Cooperative Society [2003] OJ L 207/1; Council Regulations (EEC) No 2137/85 on the European Economic Interest Grouping [1985] OJ L 199/1

supplemented and specified in the specific act pursuant to what the legal person in public law was founded.[8]

The Commercial Code only applies for legal persons in private law. The Commercial Code lists the legal persons in private law that are considered companies. A company is a general partnership, limited partnership, private limited company, public limited company or commercial association. Other companies may also be prescribed by law (Commercial Code § 2). Also the European Company, Cooperative Society and Economic Interest Grouping are considered to be legal persons in private law.

The private limited company, public limited company and commercial association have corporate management structures (governing bodies) as the general partnership and limited partnership are merely people's unions (each member may participate in managing).

The provisions in the Commercial Code about duties and liability of members of a directing body are separately provided for each different type of company (although being quite similar). There are no significant differences between director's duties in private and public limited companies.

1.2.3 Listed/non-listed companies

There are no substantial discrepancies between listed and non-listed companies regarding the regulation of director's duties and liabilities (except some additional requirements for financial reports publication and organising the general meeting of listed company's shareholders). Also, local stock exchange (NASDAQ OMX Baltic) has enforced its rules applicable to stock market participants and some of these rules specify director's duties and liabilities (for example, rules about insider information). Corporate Governance Recommendations[9] are also applicable for listed companies but they only specify some proceedings and do not impose additional director's duties.

1.2.4 State controlled companies

Currently state controlled companies (legal persons in private law) are governed by the General Part of the Civil Code Act, Commercial Code and sector-specific acts similarly as other, privately owned, companies[10]. Therefore there are no specific requirements regarding director's duties deriving only from the state ownership. Corporate Governance Recommendations are also applicable for state-controlled companies.

[8] For example according to The Bar Asscociation Act the Estonian Bar Association's directing body has to manage the association and to administer its assets, but also to organize the continuing training of attorneys
[9] Corporate Governance Recomendations. November 2004. Available: http://www.ecgi.org/codes/documents/cg_recommendations_2005_en.pdf.
[10] Until 2004 the state ownership in private companies was regulated by specific act *Riigi poolt eraõiguslike juriidiliste isikute asutamise ja nendes osalemise seadus* RT I 1996, 48, 942 (Foundation and Participation in Legal Persons in Private Law by the State Act),, repealed april 2004

1.3 The Board of an Estonian company

In Estonia the board structure of companies is two-tier and hence the supervisory organ will appoint the members of the management organ. No person may at the same time be a director and a member of the controlling body. The organs, who are authorised to appoint, are also authorised to dismiss the directors.[11]

The General Part of the Civil Code Act, § 31 provides:

> (1) The bodies of a legal person in private law are the general meeting and the management board unless otherwise provided by law.
>
> (2) The management board is the directing body of a legal person in private law. If the law provides for the existence of a supervisory board, the supervisory board is also a directing body.

According to Commercial Code the directing bodies for public limited companies are: shareholders; general meeting; supervisory board, consisting of a minimum of three natural persons, elected for the period of five years maximum; management board, consisting of one or several natural persons, elected for the period of three to five years.

<u>Competence of the general meeting</u> (Commercial Code § 298) **-** (1) A general meeting is competent to: 1) amend the articles of association; 2) increase and reduce share capital; 3) issue convertible bonds; 4) elect and remove members of the supervisory board; 5) elect an auditor; 6) designate a special audit; 7) approve the annual report and distribute profit; 8) decide on dissolution, merger, division or transformation of the public limited company; 9) decide on conclusion and terms and conditions of transactions with the members of the supervisory board, decide on the conduct of legal disputes with the members of the management board or supervisory board, and appointment of the representative of the public limited company in such transactions and disputes; 10) decide on other matters placed in the competence of the general meeting by law.

<u>Competence of the supervisory board</u> (Commercial Code § 316) **-** the supervisory board shall plan the activities of the public limited company, organize the management of the public limited company and supervise the activities of the management board. The supervisory board shall notify the general meeting of the results of a review.

<u>Competence of the management board</u> (Commercial Code § 306) - The management board is a managing body of the public limited company which represents and manages the public limited company.

[11] Andres Tupits, „The Duties and Liabilities of Directors un:Lder EU Company Law“ International and Comparative Corporate Law Journal, Vol.2, issue 3, Kluwer Law International 2000 390

2 THE CONCEPT OF COMPANY DIRECTOR IN ESTONIA

2.1 *De jure* directors

2.1.1 Requirements to become a *de jure* director

A person may become a *de jure* director on the basis of his or her election by the supervisory board or by court decision.

Commercial Code § 309 states that the directors shall be elected and removed by the supervisory board. In order to elect a director, his or her consent is required. An entry will be made into commercial register regarding the election of the director. An entry shall be held as correct with regard to a third person, except if the third person knew or should have known that the entry is not correct (Commercial code § 34 2). However, the duties and liabilities of the director, also the powers to represent the company, commence from his or her election, not from respective entry in the commercial register (which is considered to be declarative only).

In addition to election, a person may become a de jure director on the basis of the court decision as of the moment the court decision comes into force.

Commercial Code § 310 states that with good reason, a court may appoint a new member of the management board to replace a withdrawn member of the management board on the petition of the supervisory board, a shareholder or other interested person. The authority of the court-appointed member of the management board shall continue until appointment of a new member of the management board by the supervisory board.

For the legal relationship between a director and a legal person to be established, the following requirements must be met:

1. There exists the director’s consent to be elected the member of the management board (prior consent or later approval);
2. There exists the valid decision taken by supervisory board to elect the person as the director or effective court decision to appoint the person as the director; and
3. Relevant decision to become a director has been received by the director.

The legal relationship that is created automatically pursuant to law and articles of association between a director and a company is similar to contractual relationship (authorization agreement) to which both the specific acts for companies and also Law of Obligations Act apply. In addition to abovementioned legal relationship, the director and the company may also enter into additional separate authorization agreement, specifying the relationship terms and governed purely by contractual law.[12]

Law of Obligations Act § 619 states that by an authorization agreement, one person (the mandatary) undertakes to provide services to another person (the mandator) pursuant to an agreement (to perform the mandate) and the mandator undertakes to pay remuneration to the mandatary therefor if so agreed.

All statutory duties and liability of the director are fully applicable to the *de jure* director and may only be restricted internally (between the company and the director), but not towards third persons.

2.1.2 Who can become *de jure* director?

General Part of Civil Code § 31 7 states that only natural persons with active legal capacity may be members of the management board or a body substituting for the management board of a legal person unless otherwise provided by law.

Commercial Code § 308 states that the director (member of the management board) of the public limited company must be a natural person with active legal capacity. The director need not be a shareholder. A member of the supervisory board shall not be a director. The articles of association may prescribe other persons who shall not be directors.

A person with respect to whom a court has, pursuant to the Penal Code, imposed a prohibition on acting as a director or a prohibition to engage in enterprise, a person who is prohibited from operating within the same area of activity as the public limited company, or a person who is prohibited to act as a director on the basis of law or a court decision shall not be a member of the management board.

The duties and liabilities apply only to individual directors. A legal person as a legal abstraction may only act through natural persons. Therefore in Estonian law only natural persons may form the directing body (management board or supervisory board)[13].

Board of directors, acting as a body, is not subject to specific duties and liabilities. If the management board has more than two members, the members of the management board shall elect a chairman of the management board from among themselves, who shall organize the activities of the management board (Commercial code § 311). However, natural persons who form the board of directors are individually liable for board of directors' actions.

Different sectoral requirements may apply. In the financial sector, in particular, the prudential supervision of regulated entities is provided by specific legal act Credit Institutions Act 1999 (official gazette RT I 1999, 23, 349; 13.12.2011, 5; in Estonian *Krediidiasutuste seadus,* abbreviation KAS). Only persons who have the education, experience and professional qualifications necessary to manage a credit institution and who have an impeccable business reputation may be elected or

[12] Saare, *op.cit.* 486
[13] Saare, *op.cit.* 482

appointed managers of credit institutions or financial holding companies (Credit Institutions Act § 48 2).

2.2 *De facto* director

The concept of *de facto* director has been recognised and analysed in Estonian law mostly in connection with litigation. Company law does not formally regulate the existence and activities of a *de facto* director. However, the concept of *de facto* director is accepted by courts in penal law cases. Non-formal, *de facto* directors may manage the company beside (or even instead of) formal, *de jure* directors or fully independently, not having any formal connection to the company.

A person may be regarded as a *de facto* director if he/she is a natural person with active legal capacity who manages the company without ever being formally appointed as *de jure* director[14].

The Estonian Supreme Court has emphasised in many cases that when the term of directorship has ended, the director no longer has powers to represent the company without shareholders' explicit approval, even if the director continues acting as the member of the management board. In such cases the director has become a *de facto* director instead of a *de jure* director[15].

Currently the position of *de facto* director is under Estonian law relevant only in penal law defining the person's penal liability and such position should not bring about to the person any obligations towards the company (as to *de jure* director), thus the duties of loyalty and care should not apply to de facto director[16].

2.3 Shadow director

In Estonian law the concept of a shadow director (distinct from *de facto* director) has not been thoroughly analysed. However, the Commercial Code includes a regulation of liability for situations when a person (who could be in my opinion considered a shadow director) influences a company's member of the directing body to act harmfully to the company.

Commercial Code § 289² (extract):

1. A person, who, by misusing his or her influence, influences a member of the management board or supervisory board to act contrary to the interests of the public limited company, is liable to compensate any damage incurred thereby to the public limited company.
2. In the event specified in subsection (1) of this section, a member of the management board or supervisory board who violated his or her obligations shall be jointly liable with the person who influenced him or her unless he or she proves that he or she has performed his or her obligations with due diligence.

[14] Marko Kairjak, „Faktilise ühingujuhi karistusõiguslik vastutus", Juridica VII/2011 540
[15] Estonian Supreme Court's Civil Chamber cases 3-2-1-65-08 [2008] (RT III 2008,39,261); 3-2-1-92-08 [2008] (RT III 2008,46,311)
[16] Kairjak *op.cit.* 543

3. In the case specified in subsection (1) of this section, the persons who derived gains from such damage shall also be held liable jointly with the person who misused his or her influence.

The director's duties should not apply to a shadow director as there is no legal relationship between the company and the shadow director.

2.4 Directors in group companies

There are no specific arrangements for directors in companies which belong to a group of companies. All requirements applicable to "normal" directors apply. Parent companies and/or other shareholders have not been treated as *de facto* or shadow directors by courts but such approach is theoretically possible as Commercial Code § 289^2 may apply also to the companies acting as a shadow director.

However, according to general private law the shareholders or members of a legal person and the members of the directing bodies of a legal person shall act in accordance with the principle of good faith and consider each other's legitimate interests in their mutual relations (General Part of the Civil Code Act § 32). This is a principle of good faith (*bona fide*) in mutual relations (see also report's p 3.3.). The more influence the shareholder has over the management of the company, the more extensive is the obligation to consider other's legitimate interests.

The good faith principle applicable to legal person's members' internal relations includes the obligation to contribute into the management of the legal person and not to harm legal persons' or its members' interests. Related to this are the organ members' obligation to provide information, restrictions on voting-rights and also the legal person's obligation to treat its members equally[17].

The Commercial Code specifically regulates shareholder's liability. A shareholder shall be liable for any damage wrongfully caused to the public limited company, another shareholder or third persons, in the capacity of shareholder. A shareholder shall not be liable for any damage caused if the shareholder did not participate in the adoption of the resolution of the general meeting which was the basis for the cause of damage or if the shareholder voted against the resolution (Commercial Code § 289).

[17] Saare, *op.cit.* 483

3 Scope of director's duties under Estonian law

Under Estonian civil and company law the authority of directors (members of the management board) flows directly from the statute (thus being similar to German law), but still there are some fiduciary elements.

The regulation for legal person's bodies is prescribed in the General Part of the Civil Code Act, § 31 as follows:

(1) The bodies of a legal person in private law are the general meeting and the management board unless otherwise provided by law.

(2) The management board is the directing body of a legal person in private law. If the law provides for the existence of a supervisory board, the supervisory board is also a directing body.

(3) The competence of a body of a legal person in private law shall be prescribed by law, the articles of association or the partnership agreement. The competence of a body of a legal person shall not be transferred to any other body or person.

(4) The bodies of a legal person in public law and their competence shall be prescribed by law.

(5) The activities of a body of a legal person are deemed to be the activities of the legal person.

(6) A member of a body of a legal person shall not transfer his or her rights as a member of the body arising from law unless otherwise provided by law.

(7) Only natural persons with active legal capacity may be members of the management board or a body substituting for the management board of a legal person unless otherwise provided by law.

The legal person's organ (body) is an inalienable part of legal person's structure, not being an independent subject itself. The organ performs the duties of the legal person and must act in legal person's interest. The same principle applies to formation of the legal relationship between the legal person and its organ's members. The doctrine of the active legal capacity of the legal person (provided in the General Part of the Civil Code Act and specific acts governing the legal persons in private law) is based on the historical *organ theory* which contradicts to the *representative theory*. According to the *organ theory* all activities of an organ acting within its powers are attributable to the legal person as they were its own activities. According to *representative theory* the organ's activities are considered to be performed only by acting as the representative of the legal person, thus excluding the automatic attribution of organ's member's unlawful acts to the legal person. Therefore the organ has a different legal status compared to contractual representative or assistant who acts as independent person in the interest of the legal person.[18]

[18] Saare, *op.cit.* 482

The legal relationships of a legal person and its directing body may be divided into two groups:

1. Internal relationship: relationships between the legal person and its directing body or between the different bodies of the legal person aimed at organising the internal functioning of the legal person.
2. External relationship: relationships between the legal person or its bodies and third persons[19].

Under Estonian civil law and company law there are three main types of director's duties, notably

(a) The general duty of *bona fide*

(b) The general duty of care

(c) The general duty of loyalty, and

(d) A set of specific duties.

All these are general standards that must be, in case of a dispute, analysed and interpreted by a court of law. Therefore referring to case law is inevitable for deciding whether the director has properly fulfilled these quite flexible duties.

In addition to general standards (duty of *bona fide,* duty of care, duty of loyalty) there are some more specific rules provided in the General Part of Civil Code Act and Commercial Code.

The general duty of *bona fide* is provided in the General Part of the Civil Code § 32 and is applicable to all mutual relationships within the legal person, including the relationship between the directors and the shareholders.

The general duties of members of a directing body of a legal person are defined in the General Part of the Civil Code Act § 35: the members of a directing body of a legal person shall perform their obligations arising from law or the articles of association with the diligence normally expected from a member of a directing body and shall be loyal to the legal person. These main concepts are divided into more specific sub-concepts as described below.

These general duties, applicable also to company directors are prescribed in more detail on Commercial Code and in some cases also in sector-specific acts.

In addition to general duties applicable to all members of the legal person's directing body, there are some specific rules provided in the Commercial Code and thus applicable only to company directors (obligation to organise accounting, duty to file for bankruptcy).

[19] Kristjan Tamm, „Äriühingu juhtorgani liikme deliktiline vastutus äriühinguga seotud kuritarvituste korral", Juridica VI/2006 397

3.1 The general duty of *bona fide*

General Part of the Civil Code § 32 states that the shareholders or members of a legal person and the members of the directing bodies of a legal person shall act in accordance with the principle of good faith and consider each other's legitimate interests in their mutual relations.

The general duty of *bona fide* is closely related to the duty of loyalty and consists of three main elements:

1) The duty to share information
2) The duty of equal treatment
3) The restrictions of voting-rights

<u>The obligation to share information:</u>

The shareholders or members of the legal person and the members of the directing bodies must disclose and share with each other all the information that is relevant for the company or is in their common interest (for example, before the supervisory board decides on giving a consent to the management board for transaction which is beyond the scope of everyday economic activities, the supervisory board members should disclose to each other all the information that could significantly influence the decision).

<u>The duty of equal treatment:</u>

The duty of equal treatment is additionally emphasized in company-specific legal acts and it is mainly a company's duty towards its members. All legal person's bodies who exercise their voting rights should treat the members of the legal person equally under equal circumstances. For example, a majority shareholder may not pass a decision of share capital reduction by the cancellation of shares if such method would cause a disproportionate loss of shares to the minority shareholder.

<u>The restrictions of voting-rights:</u>

The member of the legal person may not misuse his/her voting rights and vote for a decision that gives him/her or to the third person benefits and is detrimental to the legal person or other legal person's members. For example, the majority shareholder may not decide in favour of a transaction with the shareholder's other company, if such transaction is harmful to the first company[20].

3.2 The general duty of care

One of the main general duties that are deriving from the legal relationship between the legal person and the member of the legal person's directing body is the general duty of care.

[20] Varul, Kull, Kõve, Käerdi, *op.cit.* 114,115

3.2.1 Principle and sources

The duty of care is the objective behavioural standard (guideline) the director must comply with when acting within his/her legal relationship with the legal person. Such standard allows assessing the director's fulfilment of his/her main tasks (managing, representing, controlling and supervising the company and planning its activities) and specific tasks (providing information and reports to supreme organ, organizing the accounting, filing for bankruptcy etc).[21]

The duty of care standard required from directors is provided in the following legal acts:

1. General Part of the Civil Code Act (§ 35 extract): the members of a directing body of a legal person shall perform their obligations arising from law or the articles of association with the diligence normally expected from a member of a directing body.
2. Commercial Code (§ 315 1): a member of the management board shall perform his or her duties with due diligence[22].
3. Law of Obligations Act (§ 620): upon the performance of a mandate, the mandatary shall act in a loyal manner with respect to the mandator and exercise the necessary level of diligence commensurate with the nature of the mandate. A mandatary shall perform the mandate to the maximum benefit of the mandator in the light of and according to the mandatary's knowledge and abilities and shall prevent any damage to the property of the mandator. In addition, a mandatary who is acting for the purposes of the mandatary's economic or professional activities shall apply the generally recognised skills of the mandatary's profession.
4. Credit Institutions Act (§ 48 4):[23]the managers and members of staff of a credit institution are required to act with the prudence and competence expected of them and according to the requirements for their positions and the interests of the credit institution and the clients thereof.

As mentioned above (§ 2.2.) the legal relationship between a director and a company is similar to a contractual relationship (authorization agreement) to which both the specific acts for companies and also Law of Obligations Act apply. Therefore also the principle provided in Law of Obligations Act (§ 24 1) applies - if the director has, according to the general duty of care, done everything reasonably possible to achieve the result, he/she cannot be held liable for breaching his/her duties towards the legal person[24].

3.2.1 Elements of the general duty of care

The general duty of care consists of three main elements (obligations):

1. The duty to be diligent;
2. The duty to be sufficiently informed for making decisions; and
3. The duty to restrain from taking unnecessary risks to the company.

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[21] Saare, *op.cit.* 487, also Varul, Kull, Kõve, Käerdi, *op.cit.* 129
[22] In the official translation of the Commercial Code (www.legaltext.ee) the term *korraliku ettevõtja hoolsusega* has been translated as *due diligence,* although it could also be translated more accurately as *with the care (or diligence) of a decent entrepreneur.*
[23] Applicable only to credit institution's director in addition to general duties deriving from General Part of Civil Code Act, Commercial Code and Law of Obligations Act
[24] Saare, *op.cit.* 488

According to Estonian case law[25] the general duty of care also requires from the company director acting in the most economically feasible (reasonable) way. Such principle is also provided in Commercial Code § 306 2 - The management board is required to act in the most economically purposeful manner.

In one of the more recent cases[26] the Estonian Supreme Court decided that the director had committed the breach of duties when he sold the company's real estate on unfavourable terms and the director should cover the loss.

The duty to be diligent requires that when acting on behalf of the legal person the member of the governing body should exercise more care than an average person would do.

According to § 24 of Law of Obligations Act if a party is obligated to do all that is reasonably possible to achieve a result, the party is obligated to make such efforts as reasonable persons in the same field of activity or profession would make under the same circumstances.

Therefore the expected standard of care of the member of the governing body is not compared with an average reasonable person but with higher standard. That is, it is compared to the standard of an average, reasonable business leader. The required level of diligence also depends on the scope and specialty of the company, but also on the background, qualification and specific obligations of the member of the governing body.[27]

The evaluation of whether the director has followed the duty to be sufficiently informed for making decisions and the duty to restrain from taking unnecessary risks to the company must be done considering the concrete circumstances separately for each legal person.

The duty to be sufficiently informed requires performing the control over the circumstances that might influence carrying out of the specific deed or reaching the desired goal. Depending on circumstances it might be necessary to conduct a research, order an expert evaluation or analyses, and involve specialists[28].

The duty to restrain from taking unnecessary risks to the company is related foremost with the transactions and deeds that are performed on behalf of the legal person and that are necessary for achieving the purpose of the legal person or replacing its activities and which bring about the obligations to the legal persons. Especially the company directors must evaluate the economical risks when acting, as almost every economical activity involves taking risks. Therefore the risks must be optimally mitigated. Usually there must be a correlation between the risks taken and the profit or loss expected. The member of the legal person's governing body must refrain from taking such risks that, upon realization, could endanger the continuity of the legal person's activities. Taking such risk would be clearly unnecessary.[29]

[25] Estonian Supreme Court's Civil Chamber cases 3-2-1-36-06 [2006] (RT III 2006,21,195); 3-2-1-41-05 [2005] (RT III 2005,17,181); 3-2-1-67-03 [2003] (RT III 2006, 21,206); 3-2-1-45-03 [2003] (RT III 2003,18,173); 3-2-1-41-03 [2003] (RT III 2003, 17, 164)
[26] Estonian Supreme Court's Civil Chamber case 3-2-1-33-10 [2010] p 18
[27] Tiivel, *op.cit* 624, 625
[28] Varul, Kull, Kõve, Käerdi, *op.cit.* 130
[29] *Ibid,* 130-131

The Supreme Court has in a court decision delivered on 14 December 2011[30] comprehensively analysed the director's duty not to take unnecessary business risks and stated that taking risks that exceed company's everyday business activities and are contrary to the company's supervisory board's guidelines is obviously unjustified. The court also confirmed that the director's duties to adhere to the supervisory board's lawful decisions and to act in the most economically purposeful manner have been established in law only for protection of company (i.e. only the company is entitled to sue and creditors or shareholder may not ground their claims on breach of these duties).

3.3 The general duty of loyalty

The general duty of loyalty requires that the legal person's governing body's member must prefer in his/her actions the interests of the legal person over his/her personal or third parties' interests.

3.3.1 Principle and sources

The duty of loyalty standard required from directors is provided in the following legal acts:

1. General Part of the Civil Code Act (§ 35 extract): the members of a directing body of a legal person shall be loyal to the legal person;
2. Commercial Code (§ 312 1) prohibition on competition (in detail below);
3. Commercial Code (§ 313 1) preservation of business secrets (in detail below);
4. Commercial Code (§ 281) prohibited loans;
5. Law of Obligations Act (§ 620): upon the performance of a mandate, the mandatary shall act in a loyal manner with respect to the mandator and exercise the necessary level of diligence commensurate with the nature of the mandate. A mandatary shall perform the mandate to the maximum benefit of the mandator in the light of and according to the mandatary's knowledge and abilities and shall prevent any damage to the property of the mandator. In addition, a mandatary who is acting for the purposes of the mandatary's economic or professional activities shall apply the generally recognised skills of the mandatary's profession; and
6. Credit Institutions Act (§ 48 4):31 the managers and members of staff of a credit institution are required to act with the prudence and competence expected of them and according to the requirements for their positions and the interests of the credit institution and the clients thereof.

The member of the governing body must avoid conflicts of interest and not misuse his/her legal position. Loyalty requires faithfulness and fidelity and prohibits a person from preferring someone else's (or their own) interests and over the company's interests. The conflicts of interest usually arise when the member of the governing body is personally interested in certain transaction or deed because he/she is a party to the transaction or represents a party to the transaction. Such transactions are generally null and void or invalid pursuant to law.

[30] Supreme Court Criminal Chamber case no 3-1-1-89-11 [2011]
[31] Applicable only to credit institution's director in addition to general duties deriving from General Part of Civil Code Act, Commercial Code and Law of Obligations Act

The duty of loyalty applies to the member of the governing body during his/her entire term. The duty to preserve business secrets is also applicable after the term of directorship ends, as long as the company has justifiable interest in keeping such secret[32].

3.3.2 Elements of the duty of loyalty

The duty of loyalty standard is more specified standard (containing also some rules) for the members of the governing body.

The general duty of loyalty contains following main rules:

1. The duty of non-competition;
2. The duty of preservation of business secrets;
3. The prohibition of granting a loan to the member of the management board; and
4. The prohibition of deciding on transactions and disputes between the legal person and the member of the management board.

3.3.2.1 Duty of non-competition

The duty of non-competition is specifically provided in the Commercial Code § 312. § 312 1 states that without the consent of the supervisory board, a member of the management board shall not:

1) Be a sole proprietor in the area of activity of the public limited company;

2) Be a partner of a general partnership or a general partner of a limited partnership which operates in the same area of activity as the public limited company; or

3) Be a member of a managing body of a company which operates in the same area of activity as the public limited company, except if the companies belong to one group.

§ 312 2 states that if the activities of a member of the management board are in conflict with this duty, the public limited company may demand that the member of the management board terminate the prohibited activity, transfer the income received from the prohibited activity to the public limited company and compensate for damage to the extent exceeding the claimed income.

3.3.2.2 Duty to preserve business secrets

The duty of preservation of business secrets is specifically provided in the Commercial Code § 313.

§ 313 1 states that the members of the management board shall preserve the business secrets of the public limited company.

[32] Varul, Kull, Kõve, Käerdi, *op.cit.* 131

§ 313 2 states that he public limited company shall not claim compensation for any damage caused by violation of this obligation if the members of the management board acted in accordance with a lawful resolution of the general meeting or of the supervisory board.

The member of the company's governing body must avoid the disclosure of the information which the company has legitimate interest to keep secret, mostly if disclosure of such information would deteriorate the company's competitiveness in the market[33]. In most cases the court decides the scope of information that is considered to be a business secret.

According to the Penal Code § 377 unjustified disclosure and use of a business secret is punishable under criminal law.

3.3.2.3 Prohibition to grant a loan

The prohibition of granting loan to the member of the management board is specifically provided in the Commercial code § 281.

§ 281 1 states that a public limited company shall not grant a loan:

1) To one of its shareholders whose shares represent more than 1 per cent of the share capital;

2) To a shareholder or member of its parent undertaking, whose shares represent more than 1 per cent of the share capital of the parent undertaking;

3) To a person to acquire shares of the public limited company; or

4) To a member of its management board or supervisory board or its procurator.

3.3.2.4 Prohibition to decide on insider loans

The prohibition of deciding on transactions and disputes between the legal person and the member of the management board is specifically provided in the Commercial Code § 317 8.

Commercial Code § 317 8 states that the supervisory board shall decide on conclusion and terms and conditions of transactions with members of the management board and it shall also decide on the conduct of legal disputes with the members of the management board. The supervisory board shall appoint a representative of the public limited company for the conclusion of the transactions and conduct of the legal disputes.

3.4 Specific duties

In addition to general standards (duty of care, duty of loyalty) the following specific rules are provided in the General Part of Civil Code Act and Commercial Code.

[33] *Ibid,* 132

The duty to adhere orders of the supervisory board:

Commercial Code § 306 1 states that the management board shall, in managing, adhere to the lawful orders of the supervisory board. Transactions which are beyond the scope of everyday economic activities may only be concluded by the management board with the consent of the supervisory board.

The duty to provide information to supervisory board and shareholders:

Commercial Code § 306 2 states that the management board shall present an overview of the economic activities and economic situation of the public limited company to the supervisory board at least once every four months and shall immediately give notice of any material deterioration of the economic condition of the public limited company or of any other material circumstances related to the economic activities of the public limited company. The management board shall also notify of any circumstances related to the private limited companies connected to the public limited company, which may significantly affect the operation of the public limited company.

The duty to submit a bankruptcy petition[34]:

General Part of Civil Code Act § 36[35] states that if a legal person is clearly permanently insolvent, the members of the management board or the body substituting for the management board shall submit a bankruptcy petition.

Commercial Code § 306 3^1 states that if a public limited company is insolvent and the insolvency, due to the company's economic situation, is not temporary, the management board shall promptly but not later than within twenty days after the date on which the insolvency became evident, submit the bankruptcy petition of the public limited company to a court.

The duty to organize accounting:

Commercial Code § 306 4 states that the management board shall organize the accounting of the public limited company.

The duty to be vigilant:

Commercial Code § 306 7 states that the management board shall guarantee the application of necessary measures and above all, the organization of internal audit in order to detect, as early as possible, any circumstances which likely to pose endanger the operation of the public limited company.

Specific duties for financial sector

Although the general rules regarding director's duties (*duty of care, duty of loyalty*) and liability apply to the credit institution director also, there is some more detailed wording provided in Credit Institutions Act. For example: The managers and members of staff of a credit institution are required to act with the prudence and competence expected of them and according to the requirements for their positions and the interests of the credit institution and the clients thereof. The managers and members of staff of a credit institution are required to give priority to the economic interests of the credit

[34] Related to this duty is also a director's duty to call a special general meeting in case the net assets of the company are less than one-half of the share capital or less than the minimum amount of share capital provided by law (Commercial Code § 292 1).

[35] Applicable to all legal persons

institution and the clients thereof over their own personal economic interests (Credit Institutions Act § 48 4,5).

3.5 The time span of duties

The duties of the director begin from his/her election by the supervisory board (upon director's consent), not from the respective entry in the commercial register[36].

The entry in the commercial register (both for registering the beginning or the end of director's term) is only declarative and is only relevant in regard to third persons[37].

An entry shall be held as correct with regard to a third person, except if the third person knew or should have known that the entry is not correct. An entry shall be deemed not to apply with regard to transactions which are performed within fifteen days after the entry is made if a third person proves that the third person was not aware nor should have been aware of the content of the entry (Commercial Code § 34).

The duties of the director end automatically by the expiry of directorship's term, unless director's powers have been prolonged by the supervisory board.

In respect of the director's duty to preserve business secret survives the expiry of the directorship's term, the director must not disclose (during a reasonable period) the company's business secrets even after he/she has been dismissed as the director (see also report's p 3.6.)

3.6 To whom the duties are owed?

The director's duties are generally owed to the company. The director is not regarded as the fiduciary to the shareholders, instead the director should serve the company (as the legal person) and its stakeholders. The legal relationship between a director and a company is similar to contractual relationship, (authorization agreement, see also report's p 2.2.) and therefore the relevant provisions of the Law of Obligation Act apply and the director is considered to be liable to the company. As the activities of a body of a legal person are deemed to be the activities of the legal person[38] there are generally no direct obligations between the director and company's creditor created.

Due to his/her legal position in the legal person, the member of the legal person's directing body does not have any kind of legal relationship with the legal person's creditor, unless he/she breaches a duty

[36] Nevertheless, according to Commercial Code § 33 7 an application for amendment of registry information shall be immediately submitted to the commercial register if the data entered in the commercial register change, including in the case of appointment, removal or change of the right of representation of a member of the management board of a company or a liquidator, or dissolution of a company.
[37] Estonian Supreme Court's Civil Chamber case 3-2-1-89-07 [2007] p 13 – when the court officials must deliver procedural documents to the legal person's representative, the court must not rely only on information available in the Commercial Register (which is considered declarative) when defining who is the legal representative of the legal person, but also must consider other available information from other sources (for example if the court has received a shareholder's decision about director's removal, the court must honor such decision)
[38] General Part of the Civil Law Act § 31 5

that is established for the protection of the creditor (duty to organize accounting, duty to file for bankruptcy). Therefore the obligations of the legal persons towards the creditor cannot be extended to the member of the legal person's directing body and the creditor may only demand the fulfilment of obligations from the legal person, but not from the legal person's member of the management body[39].

Accordingly, in case the director has caused damage to the public limited company by violation of his/her obligations, the company's creditor may only claim for payment of compensation to a public limited company for such damage if the assets of the public limited company are not sufficient to satisfy the claims of the creditor. In the case of declaration of bankruptcy of a public limited company, only a trustee in bankruptcy may file a claim on behalf of the public limited company (Commercial Code § 315 4).

Nevertheless, the creditor may claim the compensation for his/her own benefit if the director has breached a duty that had specifically been established for the protection of the creditors (duty to submit a bankruptcy petition, duty to organize accounting, duty to inform the creditors about the capital reduction, liquidation, merger and restructuring).

These duties may be regarded as the duties also owed to the company's creditor and thus entitling the creditor to claim for payment of compensation directly to the creditor.

For example, in case the director has not submitted a bankruptcy petition in timely manner, the director may be held liable both to the company and to the company's creditor. Such director's direct liability to the company's creditor derives from the fact that the duty to submit a bankruptcy petition is a statutory requirement with the purpose of protecting creditors' interests[40].

However, the duty of care is solely owed to the company and not to the creditors.

Additionally, the Commercial Code specifically prescribes the right of claim in case the damage has been wrongfully caused as a result of a merger. The director can be held liable to the company and shareholders, but also to creditors.

Commercial Code § 403 6 - The members of the management board and supervisory board, or the managing partners of a merging company shall be jointly liable to the company, the partners or shareholders, or the creditors of the company for any damage wrongfully caused by the merger.

There are no differences depending on whether those persons are established in a different Member State.

[39] Varul, Kull, Kõve, Käerdi, *op.cit.* 127
[40] Varul, Kull, Kõve, Käerdi, *op.cit.* 135

3.8 Relationship between the different duties

The director's general duties and specific rules are cumulative and there are no priorities among the statutory duties. The claimants may plead the breach of all relevant duties and have the choice which remedies to invoke. In case of a conflict between a statutory duty and an obligation provided for in an agreement (including an obligation provided for in a decision by the supervisory board or the general meeting), the director should always fulfil his/her statutory duties as he/she may be held liable for breach of duty, unless he/she proves that he/she has performed obligations with due diligence[41].

Commercial Code § 315 2 states that members of the management board who cause damage to the public limited company by violation of their obligations shall be jointly liable for compensation for the damage caused. A member of the management board is released from liability if he or she proves that he or she has performed his or her obligations with due diligence.

Commercial Code § 306 2 states that the management board shall, in managing, adhere to the lawful orders of the supervisory board.

General Part of the Civil Code Act § 37 1 states that the members of a directing body shall not bear liability if they act pursuant to a lawful resolution of the general meeting or any other competent body of the legal person.

Therefore, even if the supervisory board or general meeting orders member of the management board to act in a certain way, the director should always exercise his/her best judgment and decide whether the order is lawful or not. If the order is not lawful and still performed by the director, he/she could be held liable for a breach of duty (usually duty of care).

3.9 Possibilities to ratify the breach by the shareholder

The director is not held liable if he/she acts pursuant to a lawful resolution of the general meeting or any other competent body of the legal person (General Part of the Civil Code Arc § 37 1).

In other cases, if the director has breached his/her duties, the public limited company may retroactively waive the claim against a member of the management board or enter into a contract of compromise with such member or, upon agreement with the member of the management board, limit the claim or filing thereof in another manner or reduce the limitation period.

Such retroactive waiver of limitation of director's liability is only valid and effective if:

– It is performed by the company's competent body (in case of public limited company supervisory board);
– All significant circumstances about the breach of duty were disclosed and known to the competent body; and

[41] Theoretically there might be cases where fulfillment of a contractual obligation, even if it is conflicting a statutory duty, could be diligent (for example avoids contractual penalties to the company etc)

- The competent body has explicitly expressed it waiver or limitation towards specific breach of duty.

The company's competent body's failure to act in case of a breach of duty is generally not considered as a waiver of liability[42].

The Supreme Court has noted that the company may, either in articles of association or in agreement with the director, modify the director's liability to the company, for example to prescribe liability only for wrongful acts or gross negligence.[43]

However, such waiver or limitation of liability is only valid in the legal person's internal relationship (between the company and its bodies' members) and is not effective in external relationship, which is in regard to third persons (company's creditor etc, but also bankruptcy trustee).

General Part of the Civil Code Act § 37 2 states that an obligee has the right to submit a claim for payment of compensation against members of a directing body of a legal person who cause damage to the legal person by violation of their duties, also if the legal person has waived a claim against a member of a directing body or has entered into a contract of compromise with such member. An obligee has the right to submit a claim also if the liability of a member of a directing body is restricted in comparison with the provisions of law.

Commercial Code § 315 5 states that a creditor or trustee in bankruptcy has the right to file the claim against the director for compensation of damage, caused by violation of director's obligations, to the public limited company also if the public limited company has waived the claim against a member of the management board or has entered into a contract of compromise with such member or, upon agreement with the member of the management board, has limited the claim or filing thereof in another manner or reduced the limitation period.

3.10 Policy justifications

Under Estonian law a corporation is not shareholder centric, being instead stakeholder centric. The company directors' empowerment is statute-based. The director is not regarded as the fiduciary to the shareholders, instead – the director should serve the company (as the legal person) and its stakeholders. The protection of company and other constituencies' (mainly creditors) interests is important in Estonian company law.

Although generally no direct obligations between the director and company's creditor are created (see report's p 3.10), there are provisions with the main purpose of protecting company's creditor (Commercial Code § 292 1 – director's duty to call a general meeting if net-assets of the company have decreased; § 306 3- duty to submit a bankruptcy petition).

[42] Varul, Kull, Kõve, Käerdi, *op.cit.* 142
[43] Supreme Court Civil Chamber case no 3-1-2-33-10 [2010] p 10

The indirect liability of the director to the company's creditors realizes in the creditor's possibility to demand from the director for payment of compensation to the company, either by the creditor himself or through the bankruptcy trustee. Such legal construction for the protection of company's creditor derives from German and Austrian legislation and is a modification of "creditor's right of claim" concept, which recognizes the creditor's or bankruptcy trustee's right to demand for payment of compensation from the director, based on the internal relationship between the legal person and its member of the directing body. According to *Schlechtriem* this kind of director's liability for the creditor is grounded on the director's duty also to consider company's creditors' interests. Such approach also applies in Estonian legal system[44].

One of the first and more known court cases analysing director's civil liability is *Walko* case[45]. In this case, the court disapproved the director's entering into major assets sale contract without approval from the supervisory board. The court outlined that for performing an action that might cause ending the company's activity the director must show extremely high care and loyalty to the company.

In recent well-known *Pere Leib* case[46] the court has listed the different grounds for director's liability. The dispute was between shareholders, where one shareholder claimed that the other shareholder had organized unlawfully the decrease of plaintiffs share capital in the public limited company from 50% to 25% using merger as the diluting method. The defendant was both the shareholder and the director of the company. The plaintiff claimed the payment for compensation of damages to himself. The court brought to attention that Commercial Code § 315 only regulates the director's liability to the company in the case of director's breach of duties. The shareholder of the company may not ground his claim on this provision as it only entitles the company to such claim, deriving from the contractual relationship between the company and the director. The director is liable to the creditors in case of breaching the duties that have specifically established for the protection of the creditors. Such liability is governed by tort law (§ 1043 and 1045 1 ss 7 of the Law of Obligations Act). Additionally, the director may be held liable to creditors for his/her other, personal non-contractual obligation. If the director has intentionally acted contrary to good morals, he/she might be held liable for damages caused.

However, in another case from 2009 the Supreme Court has found that the creditor is not entitled to claim the compensation of damages to the creditor himself based on the fact that the director has breached the general duty of care. The court pointed out that the general duty of care provision has been established in the Commercial Code for the protection of the company and not for the protection of the creditors[47].

Previously mentioned *Pere Leib* case illustrates well <u>the duties of the director who is also the shareholder</u>. When the director acts as a shareholder, not all duties of the director apply. General duty of *bona fide* applies (see above) according to general private law the shareholders or members of a legal person and the members of the directing bodies of a legal person shall act in accordance with the principle of good faith and consider each other's legitimate interests in their mutual relations (General Part of the Civil Code Act § 32).

[44] Maivi Ots, „Juhtorgani liikme kaudne vastutus äriühingu võlausaldaja ees", Juridica IV/2006 235
[45] Supreme Court Civil Chamber case no 3-2-1-41-05 [2005]
[46] Supreme Court Civil Chamber case no 3-2-1-7-10 [2010] p 29,30
[47] Supreme Court Civil Chamber case no 3-2-150-09 [2009] p 12

The good faith principle applicable to legal person's members' internal relations includes the obligation to contribute into the management of the legal person and not to harm legal persons' or its members' interests. If such legal obligation is infringed, the contractual liability may arise (as also provided in Commercial Code § 289) as follows:

- A shareholder shall be liable for any damage wrongfully caused to the public limited company, another shareholder or third persons, in the capacity of shareholder. A shareholder shall not be liable for any damage caused if the shareholder did not participate in the adoption of the resolution of the general meeting which was the basis of the cause of damage or if the shareholder voted against the resolution, and
- The liability under tort law also exists in the above mentioned case, therefore both claims may be submitted in parallel.

There is a significant difference between the liabilities arising from the breach of shareholder's duties or from the breach of director's duties. A member of the management board is released from liability if he or she proves that he or she has performed his or her obligations with due diligence (Commercial Code § 315), thus the director may be held liable even if the breach of duties has been caused by carelessness. For the shareholder the liability only arises if the breach of duties has been intentional (wrongful).

If the company would like to initiate legal proceedings against the director, such decision must be taken by the supervisory board. Commercial Code § 317 8 states that the supervisory board shall decide on conclusion and terms and conditions of transactions with members of the management board and it shall also decide on the conduct of legal disputes with the members of the management board. The supervisory board shall appoint a representative of the public limited company for the conclusion of the transactions and conduct of the legal disputes.

In practice the supervisory board is usually (but not obligatorily) composed of shareholder's representatives, so if there is only one shareholder (who is also the director), the related persons in supervisory board might not be willing to submit a claim against the director who has acted in line with the shareholders' wishes.

However, the creditors may under certain circumstances bring an action against the director even if the supervisory board decides not to proceed. It can either claim compensation for damages to the company or, if the assets of the public limited company are not sufficient to satisfy the claims of the creditors, claim the compensation directly to creditors themselves (Commercial Code, § 315 4; see also report's p 3.10 and 3.13.).

4 LIABILITY FOR BREACH OF DUTY

4.1 Legal basis

The general legal basis for legal person's directing body's liability is provided in the General Part of the Civil Code Act § 37(1):

> *The members of a directing body of a legal person who cause damage to the legal person by violation of their duties shall be jointly liable to the legal person. The members of a directing body shall not bear liability if they act pursuant to a lawful resolution of the general meeting or any other competent body of the legal person.*
>
> *(2) A claim for payment of compensation to a legal person for damage specified in subsection (1) of this section may also be submitted by an obligee of the legal person if the assets of the legal person are not sufficient to satisfy the claims of the obligee.*
>
> *(3) An obligee has the right to submit a claim specified in subsection (2) of this section also if the legal person has waived a claim against a member of a directing body or has entered into a contract of compromise with such member. An obligee has the right to submit a claim also if the liability of a member of a directing body is restricted in comparison with the provisions of law.*
>
> *(4) The limitation period for submission of claims against a member of a directing body of a legal person shall be five years as of violation of an obligation.*

A specific legal basis for public limited company's director's liability is provided in Commercial Code § 315:

> *(1) A member of the management board shall perform his or her duties with due diligence.*
>
> *(2) Members of the management board who cause damage to the public limited company by violation of their obligations shall be jointly liable for compensation for the damage caused. A member of the management board is released from liability if he or she proves that he or she has performed his or her obligations with due diligence.*
>
> *(3) The limitation period for assertion of a claim against a member of the management board is five years unless the articles of association of the public limited company or an agreement with the member of the management board prescribes another limitation period.*
>
> *(4) A claim for payment of compensation to a public limited company for damage specified in subsection (2) of this section may also be submitted by a creditor of the public limited company if the assets of the public limited company are not sufficient to satisfy the claims of the creditor. In the case of declaration of bankruptcy of a public limited company, only a trustee in bankruptcy may file a claim on behalf of the public limited company.*
>
> *(5) A creditor or trustee in bankruptcy has the right to file the claim specified in subsection (4) of this section also if the public limited company has waived the claim against a member of the management board or has entered into a contract of compromise with such member or, upon agreement with the member of the management board, has limited the claim or filing thereof in another manner or reduced the limitation period.*

4.2 Duty of care: conditions of liability

4.2.1 The standard of care

The director is expected to perform his/her duties with due diligence (General Part of the Civil Code Act § 35; Commercial Code § 315 1) which is normally expected from a member of a directing body. The director may be held liable even if the breach of duty has been caused as a result of carelessness (no intention or gross-negligence required, unless such limitation of director's liability is provided in articles of association or agreement with the director).

Nevertheless, the director's breach of duty may also be identified during the company's insolvency proceedings as a grave error in management. Such qualification however requires intentional violation of duties or gross negligence.

Bankruptcy Act § 28 2 provides that if it becomes evident in bankruptcy proceedings that the cause of the insolvency of the debtor is a grave error in management, the court shall indicate such error in the court decision. Intentional violation of the obligations of a debtor who is a natural person or of a member of a management body of a debtor who is a legal person or violation of such obligations through gross negligence is deemed to be a grave error in management.

The judge will eventually decide what type of action has been a grave error in management. The court decision identifying grave error in management does not automatically establish director's liability, but could be used as evidence to initiate and conduct a separate proceeding against the director.[48]

Dual objective/subjective standard

The standard of care is determined case specifically. The required level of diligence depends on the scope and specialty of the company, but also on the background, qualification and specific obligations of the member of the governing body (see also report's p 3.5.). For example, the standard of care is different for a director of credit institution or for a director of hobby school. Eventually, the substance of "due diligence" shall be defined by the court.

In recent case[49] the Supreme Court decided that directors did not comply with the duty of care when the sold the company's main asset (a real-estate) in order to avoid the enforcement of the creditor's claim. Such activity may be regarded as intentionally causing insolvency which is a criminal act. In addition, by acting in such way the directors may become personally liable to company's creditors. The directors may only be released from liability if they prove that they acted with due diligence.

Business judgment rule

The business judgment rule has not been clearly stated in any statutory act, but in case law the court has distinguished between the decision process and outcome when defining the director's liability. The court has stated that the members of the management board cannot be held personally liable solely

[48] Margit Vutt „Juhtorgani kohustuse rikkumise, sealhulgas raske juhtimisvea ning kuriteotunnustega teo kindlaks tegemine pankrotimenetluse parktikas" 2008, 13 Supreme Court's homepage www.riigikohus.ee
[49] Supreme Court Civil Chamber case no 3-2-1-33-10 [2010]

for the reason that their business decisions have been detrimental or the company has become insolvent. For example the investment decisions taken by the company directors during 1997, the general period of optimism, Estonian economy-growth and stock-market upsurge, may have not seemed wise and purposeful in 1998, when the economic situation had dramatically changed. In the contrary, the decision that initially seemed detrimental to the company might have turned out to be profitable after all[50].

The general duty of care is the criterion of which fulfilment or breach determines the liability of the director. Merely the fact that the director's management has brought to the company detrimental consequences or the desired positive result has not been reached does not automatically mean that the director is liable. The detrimental consequences may also appear or the desired positive outcome may not come even if the director has fulfilled his/her duties with due diligence. Due to the fact that there is a relationship similar to authorization agreement between the director and the company, the Commercial Code § 24 applies and the director shall not be deemed to have breached his/her duties if he/she has done all that is reasonably possible to achieve a result[51].

4.2.2 The burden of proof

The burden of proof lies with the director. A member of the management board is released from liability if he or she proves that he or she has performed his or her obligations with due diligence (Commercial Code § 315). Therefore the assumption provided in law is that the director is liable and the director must prove the opposite. However, the plaintiff must prove the existence of the breach of duty.

4.2.3 Loss and loss causation

The civil liability of the director provided in the General Part of Civil Code Act and Commercial Code aims for the actual compensation of damages. According to the Law of Obligations Act § 127 the purpose of compensation for damage is to place the aggrieved person in a situation as near as possible to that in which the person would have been if the circumstances which are the basis for the compensation obligation had not incurred. According to case law the legal person may only claim for compensation for patrimonial (material) damage and not for the non-patrimonial (moral) damage.

The plaintiff must prove that the director has breached his/her duty, the loss to the company has incurred and there has been legally recognized causal link between the conduct of a director and the damage incurred.

4.2.4 Consequences of liability

In addition to the obligation to compensate the damages the liability also includes the company's entitlement to unilaterally terminate the contract with the director (to remove the director from his/her position), also to require from the director the performance of the duty and/or withhold performance of an obligation which is due from the company[52]. The agreements that the director has concluded

[50] Tiivel, *op.cit* 631
[51] Varul, Kull, Kõve, Käerdi, *op.cit.* 130
[52] *Ibid.* 137

without supervisory board's decision (when the previous decision has been statutorily obligatory) are not automatically void.

Obligatory supervisory board's decision

The supervisory board shall decide on the conduct of legal disputes with the members of the management board and appoint a representative of the public limited company for the conduct of the legal disputes (Commercial Code § 317 8). Without a supervisory board's relevant decision the company may not sue the director. The same principle applies even if the company decides on the conduct of legal disputes with the former director. In case of company's bankruptcy the bankruptcy trustee shall decide on conducting of legal dispute on behalf of the company.[53]

Joint and several liability:

Members of the management board who cause damage to the public limited company by violation of their obligations shall be jointly liable for compensation for the damage caused (Commercial Code § 315 2). The company may, upon its decision, claim for compensation of damages from one, some or all members of the management board. The joint liability provision assumes that all members of the management board are liable for breach of duty, especially in cases where law or articles of association prescribe certain duty to directing body and that duty is not fulfilled (for example duty to organize the accounting or to call for general meeting). In addition to statutory duties applicable to company's directing body there are also individual duties of the directors that are applicable only to individuals (duty to preserve business secret, non-competition duty). If such individual duty is breached, the individual director is usually solely liable[54].

4.2.5 Duration of liability:

The director may only be held liable for breach of duties that take place during his/her term of directorship. After the director resigns (or director's term expires), his/her obligations and liability deriving from duty of care cease. However, the company or a creditor may submit a claim against the resigned director (on the basis of the Commercial Code provisions) if the breach of duties took place during his/her directorship term. If the director had resigned by the time of performing the detrimental act to the company, the former director's liability may be based on tort[55].

The limitation period for assertion of a claim against a member of the management board is five years unless the articles of association of the public limited company or an agreement with the member of the management board prescribes another limitation period (Commercial Code § 315 3). Such limitation of period is not bounding to creditors or the bankruptcy trustee (Commercial Code § 315 5).

4.2.6 Exemptions and limitations

Statutory exemption: the director is not held liable if he/she acted pursuant to a lawful resolution of the general meeting or any other competent body of the legal person (General Part of the Civil Code Arc § 37 1). For public limited company's director the competent body to issue resolutions is the supervisory board. Nevertheless, the director must always exercise reasonable care to evaluate whether the supervisory board's resolution is lawful both formally and substantially.

[53] *Ibid,* 140
[54] Varul, Kull, Kõve, Käerdi, *op.cit.* 138
[55] Supreme Court Civil Chamber case no 3-2-1-44-08 [2008]

Contractual exemption: the company may, either in articles of association or in separate agreement with the director, modify the director's liability to the company. For example it may prescribe liability only for wrongful acts or gross negligence (proactive limitation of liability). However, the limitation or waiver of liability for intentional (wrongful) breach of duty is not valid (Law of Obligations Act § 106).

In other cases, if the director has breached his/her duties, the public limited company (upon competent organ's decision) may retroactively waive the claim against a member of the management board or enter into a contract of compromise with such member or, upon agreement with the member of the management board, limit the claim or filing thereof in another manner or reduce the limitation period.

However, any limitation or waiver of liability is only valid in internal relationship between the company and the director.

The expiry of the limitation period for submitting the claim: the director's liability cannot be enforced after the expiry of the limitation period for submitting the claim (usually 5 years as of breach of duty, unless the articles of association of the public limited company or an agreement with the member of the management board prescribes another limitation period). If the breach of duty has been intentional (wrongful), the limitation period for submitting the claim is 10 years. If this is the case, the plaintiff must provide evidence that the breach has been intentional.

The insurance for director's liability is available, but not widely used (more used in international group companies, but for smaller companies due to the high insurance premium).

4.3 Duty of loyalty: conditions of liability

4.3.1 The standard of loyalty

The main elements of duty of loyalty are the duty of non-competition and the duty of preservation of business secrets (Commercial Code § 312, 313). The standard of loyalty is an objective standard.

Without the consent of the supervisory board, a member of the management board shall not: be a sole proprietor in the area of activity of the public limited company; be a partner of a general partnership or a general partner of a limited partnership which operates in the same area of activity as the public limited company; be a member of a managing body of a company which operates in the same area of activity as the public limited company, except if the companies belong to one group.

To fulfil the duty of non-competition the director and company should have similar understanding of the company's area of activity (the definition in articles of association is not exhaustive as the area of company's actual activity might be wider than main activity stated in articles of association). Usually the director and the company agree on a definition of competitors in contract; however the law requires the director to exercise reasonable care throughout his/her directorship.

The members of the management board shall preserve the business secrets of the public limited company.

To fulfil the duty to preserve business secret the director and company should define substance of the business secret – what parties consider as business secret. The duty to preserve business secret does not extend to the information that is publicly available or that has to be disclosed according to law. The Supreme Court has referred to TRIPS agreement when defining the essence of a business secret.

4.3.2 The burden of proof

The burden of proof lies with the director. As there is a contractual relationship between the director and the company (similar to the authorization agreement), the Law of Obligations Act applies.

§ 103 1 states that an obligor shall be liable for non-performance unless the non-performance is excused. It is presumed that non-performance is not excused. Therefore the assumption provided in law is that the director is liable and the director must prove the opposite. However, the plaintiff must prove the existence of the breach of duty[56].

The director may be held liable even if the breach of duty has been caused as a result of carelessness (no intention or gross-negligence required, unless such limitation of director's liability is provided in articles of association or agreement with the director).

4.3.3 Loss and loss causation

The civil liability of the director provided in the General Part of Civil Code Act and Commercial Code, aims for the actual compensation of damages. According to the Law of Obligations Act § 127 the purpose of compensation for damage is to place the aggrieved person in a situation as near as possible to that in which the person would have been if the circumstances which are the basis for the compensation obligation had not incurred. According to case law the legal person may only claim for compensation for patrimonial (material) damage and not for the non-patrimonial (moral) damage.

In addition, for the duty of non-competition, the Commercial Code (§ 312 2) specifically provides that if the activities of a member of the management board are in conflict with this duty, the public limited company may demand that the member of the management board terminate the prohibited activity, transfer the income received from the prohibited activity to the public limited company and compensate for damage to the extent exceeding the claimed income.

The plaintiff must prove that the director has breached his/her duty, the loss to the company has incurred and there has been legally recognized causal link between the conduct of a director and the damage incurred. In practice it is quite difficult to prove the amount of a loss in case of breach of non-competition or confidentiality duty. Therefore often the fulfilment of such duties is guaranteed by fixed sum contractual penalties included in the agreement between the company and the director.

[56] Varul, Kull, Kõve, Käerdi, *op.cit.* 138

4.3.4 Consequences of liability

In addition to the obligation to compensate the damages the liability also includes the company's entitlement to unilaterally terminate the contract with the director (to remove the director from his/her position), also to require from the director the performance of the duty and/or withhold performance of an obligation which is due from the company. Additionally, the company may demand that the director transfer to the company the income received from the prohibited activity.

According to the Penal Code § 377 unjustified disclosure and use of business secret is punishable under criminal law.

The duty of loyalty also includes the prohibition to grant loan to the member of the management board. Transactions violating this duty are void.

Joint and several liability:

As the duty to preserve business secret and non-competition duty are usually individual duties, the individual director is usually solely liable in case of breach of duties.

4.3.5 Duration of liability:

The director may only be held liable for breach of duties that take place during his/her term of directorship. However, the duty to preserve business secret survives the expiry of the directorship's term.

The limitation period for assertion of a claim against a member of the management board is five years unless the articles of association of the public limited company or an agreement with the member of the management board prescribes another limitation period (Commercial Code § 315 3). Such limitation of period is not binding on creditors or the bankruptcy trustee (Commercial Code § 315 5).

There is a shorter limitation period for claims asserting from breach of duty of non-competition. The company may demand that the member of the management board terminate the prohibited activity, transfer the income received from the prohibited activity to the public limited company in 3 months as of the moment the company became aware of breach of duty, but not longer than 3 years as of breach of duty.

4.3.6 Exemptions

Statutory exemption: the director is not held liable if he/she acted pursuant to a lawful resolution of the general meeting or any other competent body of the legal person (General Part of the Civil Code Arc § 37 1, also specifically for duty of preserving business secret Commercial Code § 313 2). For public limited company's director the competent body to issue resolutions is the supervisory board. The supervisory board may allow the director to compete with the company or to disclose business secret.

Nevertheless, the director must always exercise reasonable care to evaluate whether the supervisory board's resolution is lawful both formally and substantially.

Contractual exemption: the company may, either in articles of association or in separate agreement with the director, modify the director's liability to the company, for example to prescribe liability only for wrongful acts or gross negligence (proactive limitation of liability). However, the limitation or waiver of liability for intentional (wrongful) breach of duty is not valid (Law of Obligations Act § 106).

In other cases, if the director has breached his/her duties, the public limited company (upon competent organ's decision) may retroactively waive the claim against a member of the management board or enter into a contract of compromise with such member or, upon agreement with the member of the management board, limit the claim or filing thereof in another manner or reduce the limitation period.

However, any limitation or waiver of liability is only valid in internal relationship between the company and the director.

The expiry of the limitation period for submitting the claim – the director's liability cannot be enforced after the expiry of the limitation period for submitting the claim (usually 5 years as of breach of duty and 3 months-3 years in case of non-competition duty's breach, unless the articles of association of the public limited company or an agreement with the member of the management board prescribes another limitation period). If the breach of duty has been intentional (wrongful), the limitation period for submitting the claim is 10 years. If this is the case, the plaintiff must provide evidence that the breach has been intentional.

4.4 Insurance against liability

The insurance for director's liability is available, but not widely used (more used in international group companies, but for smaller companies due to the high insurance premium).

5 Duties in the vicinity of insolvency

Basically the general duties of a director all remain the same in the vicinity of insolvency; the nature of the duties and the persons to whom they are owed do not change.

In addition:

1) The duty to submit a bankruptcy petition arises (for breach of duty both civil and criminal liability arises), and
2) The director is forbidden to make any payments on behalf of the company after the insolvency becomes evident (except the payments in line with due diligence).

5.1 The meaning of 'vicinity of insolvency'

The vicinity of insolvency might be defined as a company's economic situation being insolvent (the debtor is unable to satisfy the claims of the creditors; the assets of the debtor are insufficient for covering the obligations) and this insolvency is not temporary.

5.2 The duty to submit file for insolvency and to refrain from making any payment on behalf of the company

The General Part of Civil Code Act § 36 states that if a legal person is clearly permanently insolvent, the members of the management board or the body substituting for the management board shall submit a bankruptcy petition.

This duty is specified for companies in Commercial Code § 306 3^1 which states that if a public limited company is insolvent and the insolvency, due to the company's economic situation, is not temporary, the management board shall promptly but not later than within 20 days after the date on which the insolvency became evident, submit the bankruptcy petition of the public limited company to a court. After insolvency has become evident, the members of the management board shall no longer make payments on behalf of the public limited company, except in the case where making the payments in the situation of insolvency conforms to the due diligence requirements. The members of the management board shall jointly compensate to the public limited company any payments made by the public limited company after the insolvency of the company became evident which, under the circumstances, were not made with due diligence.

<u>The content of the duty:</u>

The duty to submit a bankruptcy petition is established for the protection of creditor's interest. The purpose of this duty is to avoid the situation of insolvent company continuing its activities. In order to treat all the creditors equally in the situation of limited resources the bankruptcy process must be conducted. The company itself or its creditors may submit a bankruptcy petition. For assurance that the bankruptcy petition is submitted in timely manner, the director is liable for performing this duty[57].

The legal obligation to submit a bankruptcy petition (in 20 days) arises when the company is permanently insolvent. Therefore it is crucial to understand the definition of insolvency.

According to Bankruptcy Act § 1 bankruptcy means the insolvency of a debtor declared by a court ruling. A debtor is insolvent if the debtor is unable to satisfy the claims of the creditors and such inability, due to the debtor's financial situation, is not temporary. A debtor who is a legal person is insolvent also if the assets of the debtor are insufficient for covering the obligations thereof and, due to the debtor's financial situation, such insufficiency is not temporary.

The law does not provide exact conditions under what the company is considered to be permanently insolvent. Eventually the case law must give clear guidance about distinguishing temporary and permanent insolvency.

The Supreme Court has recently made decisions defining the state of permanent insolvency and thus specifying deadline for the obligation to submit a bankruptcy decision.

The Supreme Court decided on 28 October 2011[58] that the company's state of permanent insolvency cannot be identified merely on the basis of some isolated financial figures, like amount of loss or net assets. To identify whether the company has objectively become permanently insolvent, the court must give comprehensive overall assessment to company's financial situation and probable future perspective (also evaluating business plan). The permanent insolvency of the debtor is evident, when the company's financial data gives reason to objective and professional bystander to assume that the debtor is permanently insolvent and there are evident scenarios that would help the company successfully overcome the insolvency. To make such assessment one should only consider information that was accessible at the time when alleged insolvency became evident (so called *ex ante* assessment). For example, when assessing debtor's solvency retroactively, one cannot take into consideration changes in technology development or price of raw material that influenced the realisation of debtor's business plan but could not be reasonably foreseen at the evaluated time.

The burden of proof:

The burden of proof lies with the director. As there is a contractual relationship between the director and the company (similar to the authorization agreement), the Law of Obligations Act applies - § 103 1 - An obligor shall be liable for non-performance unless the non-performance is excused. It is presumed that non-performance is not excused. Therefore the assumption provided in law is that the director is liable and the director must prove the opposite. However, the plaintiff must prove the existence of the breach of duty.

In addition to civil liability the director is also liable under penal code in case of breach of duty to submit a bankruptcy petition.

[57] Varul, Kull, Kõve, Käerdi, *op.cit.* 133
[58] Supreme Court Civil Chamber case no 3-1-1-49-11 [2011]

Penal Code § 385^1 - Failure to perform the obligation to submit a petition in bankruptcy provided by law is punishable by a pecuniary punishment or up to one year of imprisonment.

Although in case of criminal proceeding the presumption of innocence applies, the accused director must himself provide evidence to ground his allegations regarding the fulfilment of duty to submit a bankruptcy petition[59].

Loss and loss causation:

The civil liability of the director provided in the General Part of Civil Code Act and Commercial Code, aims for the actual compensation of damages. According to the Law of Obligations Act § 127 the purpose of compensation for damage is to place the aggrieved person in a situation as near as possible to that in which the person would have been if the circumstances which are the basis for the compensation obligation had not incurred. According to case law the legal person may only claim for compensation for patrimonial (material) damage and not for the non-patrimonial (moral) damage.

The Commercial Code § 306 3^1 provides specific regulation for compensation of damages in case the director has continued making payments after the permanent insolvency became evident - the members of the management board shall jointly compensate to the public limited company any payments made by the public limited company after the insolvency of the company became evident which, under the circumstances, were not made with due diligence.

The plaintiff must prove that the director has breached his/her duty, the loss to the company has incurred and there has been legally recognized causal link between the conduct of a director and the damage incurred. As the duty to submit a bankruptcy petition is provided for the protection of the creditors, also the creditor may claim from the director for the creditor itself the compensation of damages deriving for the breach of duty.

Joint and several liability:

Members of the management board who cause damage to the public limited company by violation of their obligations shall be jointly liable for compensation for the damage caused (Commercial Code § 315 2, also § 306 3^1). The company may, upon its decision, claim for compensation of damages from one, some or all members of the management board. The obligation to submit bankruptcy petition is not a joint obligation of the management board, but severe obligation applicable to each member of the management boards. Even in the case when the members of the management board have the right to represent the company only jointly, in case of submitting a bankruptcy petition such joint representation restriction does not apply and each member of the management board is entitled to submit a bankruptcy petition if necessary[60].

Period of liability:

The director may only be held liable for breach of duties that take place during his/her term of directorship. After the director resigns (or director's term expires), his/her obligations and liability deriving from duty of care cease. However, the company or a creditor may submit a claim against the resigned director (on the basis of the Commercial Code provisions) if the breach of duties took place

[59] Supreme Court Criminal Chamber case no 3-1-1-49-11 [2011] p 25
[60] Varul, Kull, Kõve, Käerdi, *op.cit.* 134

during his/her directorship term. If the director had resigned by the time of performing the detrimental act to the company, the former director's liability may be based on tort.

The limitation period for assertion of a claim against a member of the management board is five years unless the articles of association of the public limited company or an agreement with the member of the management board prescribes another limitation period (Commercial Code § 315 3). Such limitation of period is not bounding to creditors or the bankruptcy trustee (Commercial Code § 315 5).

Exemptions

Statutory exemption: the director is not held liable if he/she acted pursuant to a lawful resolution of the general meeting or any other competent body of the legal person (General Part of the Civil Code Arc § 37 1). Nevertheless, the director must always exercise reasonable care to evaluate whether the supervisory board's resolution is lawful both formally and substantially.

Contractual exemption: the company may, either in articles of association or in separate agreement with the director, modify the director's liability to the company, for example to prescribe liability only for wrongful acts or gross negligence (proactive limitation of liability). However, the limitation or waiver of liability for intentional (wrongful) breach of duty is not valid (Law of Obligations Act § 106).

In other cases, if the director has breached his/her duties, the public limited company (upon competent organ's decision) may retroactively waive the claim against a member of the management board or enter into a contract of compromise with such member or, upon agreement with the member of the management board, limit the claim or filing thereof in another manner or reduced the limitation period.

However, any limitation or waiver of liability is only valid in internal relationship between the company and the director.

In regards to the expiry of the limitation period for submitting the claim, the director's liability cannot be enforced after the expiry of the limitation period for submitting the claim (usually 5 years as of breach of duty unless the articles of association of the public limited company or an agreement with the member of the management board prescribes another limitation period). If the breach of duty has been intentional (wrongful), the limitation period for submitting the claim is 10 years. If this is the case, the plaintiff must provide evidence that the breach has been intentional.

The limitation period for criminal liability is a five year of commission of criminal offence (Penal Code § 81).

The insurance for director's liability is available, but not widely used (more used in international group companies, but for smaller companies due to the high insurance premium).

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue?

6.1.1 The company as a plaintiff

As mentioned, the director's duties are generally owed to the company. The director is not regarded as the fiduciary to the shareholders, instead – the director should serve the company (as the legal person) and its stakeholders.

In case the director has caused damage to the public limited company by violation of his/her obligations, the company has standing to sue and claim for payment of compensation to the company.

In the case of declaration of bankruptcy of a public limited company, only a trustee in bankruptcy may file a claim on behalf of the public limited company (Commercial Code § 315 4).

6.1.2 The company's creditor as a plaintiff

Also, the company's creditor may claim for payment of compensation to a public limited company for damage if the assets of the public limited company are not sufficient to satisfy the claims of the creditor.

Due to his/her legal position in the legal person, the member of the legal person's directing body does not have any kind of legal relationship with the legal person's creditor, unless he/she breaches a duty that is established for the protection of the creditor (duty to organize accounting, duty to file for bankruptcy). In latter case the creditor is entitled to claim for payment of compensation directly to the creditor.

6.1.3 The company's shareholders as plaintiffs

The shareholders are generally not entitled to claim the company's directors. In case of breach of director's duties that are owed to the company, only the company is the proper plaintiff.

6.1.3.1 In their own name

The shareholders (as any creditor) may only sue in their own name if the director breaches the duty that has been established for the protection of shareholders and the law provides *expressis verbis* possibility to raise such claim (for example in the case of merger or division of the company) or director's liability is based on tort (see also report's p 3.13 *Pere Leib* case).

The Supreme Court has analysed in *Werol* case[61] the shareholders' possibilities to hold director liable for his breach of duties that resulted in loss of share price. The court once more emphasized that the purpose of § 306 2 in Commercial Code is not to protect shareholders from loss. The court recognized that director's breach of duty (acting with the lack of economical purposefulness or ignoring supervisory board's orders) might result in reducing company's assets and thus value of shares and this way infringing the proprietary interests of the shareholders. Nevertheless, for avoidance of unequal treatment of shareholders and conflict of interest between certain shareholder and the company, the protection of shareholders' interests is carried out through the public limited company. The public limited company owes the claim against the director if the director has caused loss to the company by breach of his duties.

6.1.3.2 In the name of the company

Estonian law does not provide a possibility for shareholders' derivative suit therefore the shareholders are not entitled to present a claim against company's directors in the name of the company.[62]

6.2 Criminal and administrative sanctions

In addition to private enforcement there is criminal enforcement in case of not submitting bankruptcy petition (see report's p 5.2.) and for unjustified disclosure and use of business secret (see report's p 3.7).

Also, the court may impose a prohibition of business to the director, both during the bankruptcy process or criminal process.

According to Bankruptcy Act § 91 2 and 3 in the event of the bankruptcy of a debtor who is a legal person, the court may order that the director must not act as an undertaking, a member of a management body of a legal person, the liquidator of a legal person or a procurator until the end of the bankruptcy proceedings. If the director is convicted of a bankruptcy offence or a criminal offence relating to execution procedure, a tax offence on the basis of a court judgment, the court may order at the end of the bankruptcy proceedings that the prohibition on business applies to the debtor who is a legal person or a director also within three years after the end of the bankruptcy proceedings.

Prohibition of business is also provided in Penal Code § 49^1 the court may impose the prohibition to engage in enterprise on a convicted offender for a term from one to five years if the person is convicted of a criminal offence relating to abuse of official status or violation of official duties. A person with respect to whom a court has imposed a prohibition to engage in enterprise shall not act as an undertaking, member of the management bodies of a legal person, liquidator or procurator of a legal person or participate in the management of the legal person in any other manner during the term specified by the court.

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[61] Supreme Court Criminal Chamber case no 3-1-1-89-11 [2011] p 29.2, 29.3

[62] Margit Vutt. „Shareholder's Derivative Claim – Does Estonian Company Law Require Modernisation?". Juridica International XV 2008 82-83

7 Conflict of Laws

The Private International Law Act (2002) is applicable in cases where a legal relationship is connected with the law of more than one state. The Private International Law Act does not provide specific rules regarding insolvency law. The case law regarding conflict of laws is limited.

7.1 Company law

According to § 14 of the Private International Law Act a legal person shall be governed by the law of the state according to which the legal person is founded. If a legal person is actually managed in Estonia or the main activities of the person are carried out in Estonia, the legal person shall be governed by Estonian law. The bodies of the legal persons and the liability for the debts (duties) of the legal person are also in a scope of applicable law. Therefore, in case breach of director's statutory duties the applicable law is Estonian law.

7.2 Tort law

Claims arising from unlawful causing of damage shall be governed by the law of the state where the act or event which forms the basis for causing the damage was performed or occurred. If the consequences do not become evident in the state where the act or event which formed the basis for causing the damage was performed or occurred, the law of the state where the consequences of the act or event became evident shall be applied at the request of the injured party (Private International Law Act § 50).

If a claim arising from unlawful causing of damage is governed by foreign law, compensation ordered in Estonia shall not be significantly greater than the compensation prescribed for similar damage by Estonian law (Private International Law Act § 52).

If a non-contractual obligation has a closer connection with the law of a state other than that which would be applicable pursuant to the provisions of Private International Law Act, the law of such other state applies. A closer connection may arise in the case of a legal person, the location of the management board or the body substituting for the management board of the legal person or the place of business connected with the act or event shall be taken into consideration instead of the residence.

Therefore, the director's liability based on tort is generally governed by the law of Estonia, assuming the location of the management board is in Estonia.

7.3 Cross-border insolvency

The Supreme Court has analysed cross-border insolvency proceedings in the context of EU Council 29.05.2000 regulation no 1346/2000, in decision from 21.11.2011[63]. Under the EU regulation only bankruptcy proceeding may be regarded as a secondary winding-up proceeding in Estonia. The court ruled that as the purpose of the secondary insolvency proceeding is to protect local (minority)creditor's interest, such winding-up proceeding may be conducted in Estonia in relation with the bankruptcy proceeding in the country of centre of main interest. In referred case the Finnish company had not entered into bankruptcy proceedings, but instead into reorganisation proceedings and in such case the EU regulation for secondary winding-up is not applicable. The court also mentioned that insolvency proceedings are, according to referred EU regulation, regulated by the law of the country where the procedural acts are performed. Thus, as a general principle, the secondary insolvency procedures in Estonia should be governed by the Bankruptcy Act, unless its provisions are contradicting the EU regulation. The court also criticised the legislator for not amending the Bankruptcy Act according to EU regulation about winding-up, which makes the implementation of EU law more difficult.

[63] Supreme Court Civil Chamber case no 3-2-1-114-11 [2011]

Directors' Duties and Liability in Finland

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Contents

1 INTRODUCTION

1.1 Corporate law and directors' duties in Finland

The law governing the organisation and operations of limited liability companies in Finland is the Limited Liability Companies Act ("Companies' Act"),[1] which has recently been comprehensively amended with a goal to create a more flexible and competitive company legislation and to decrease formalities. The Companies' Act now stipulates conditions that were previously dealt with in court practice and literature.

Finnish companies are fairly free to organise their management and operations within the framework provided by the Companies' Act. In many cases the law allows deviations, however in most cases this requires a specific clause in the articles of association. The articles of association shall be registered at the Trade Register first when the company is incorporated and updated with possible changes in the course of its lifetime. The articles of association supersede the governance codes that are introduced below.

The Companies' Act applies to all limited liability companies that are registered in Finland, regardless of the size of their capital, number of shareholders and whether the company is listed or not. Certain types of limited liability companies are also subject to sector-specific regulation (i.e. banks and insurance companies)[2]. However, where these specific codes are silent, the Companies' Act applies.

1.2 Corporate landscape in Finland

Based on the statistics of the Finnish Trade Register,[3] at the end of 2011 there were 224,074 private limited liability companies and 202 public limited liability companies in Finland. The same numbers at the end of 2008 were 196,220 and 209 respectively.

Besides the Companies' Act, a limited company is subject to many other laws, obviously depending on the industry and the nature of its operations. Compliance with these laws is the responsibility of the directors. This paper discusses these laws where appropriate to explain the extent and nature of the directors' duties, however it is not feasible to list each and every one of them. Some of the important laws worth mentioning, applicable to the listed companies, are the Securities Markets Act,[4] Auditing Act[5] and Accounting Act[6] as well as the Criminal Code.[7]

Specific Corporate Governance rules have been thought best to be left to be determined within the industry. There are two main codes in Finland:

[1] 21.7.2006/624. The Companies' Act came into force 1.9.2006.
[2] 28.12.2001/1501 (Banks and other credit institutions), 18.7.2008/521 (Insurance companies).
[3] http://www.prh.fi/fi/kaupparekisteri/yritystenlkm/lkm.html.
[4] 26.5.1989/495.
[5] 13.4.2007/459.
[6] 30.12.1997/1336.
[7] 19.12.1889/39.

1. Finnish Corporate Governance Code ("Governance Code"), issued in October 2010 by The Securities Market Association.[8] The code applies to companies listed in NASDAQ OMX Helsinki Ltd ("Helsinki Stock Exchange"), unless it would clash with the mandatory laws of the seat of the company. Comply or explain-principle gives companies the possibility to deviate from a recommendation of the code, however, by explaining the reasons for doing so. This deviation shall be included in the company's annual governance statement and presented on the company's website. Although non-listed companies are not obliged to adopt the Governance Code, they are free to do so.
2. Helsinki Takeover Code 2006 ("Takeover Code") issued by The Takeover Panel of the Central Chamber of Commerce of Finland.[9] Public takeover bids in Finland are regulated by law. The Takeover Code supplements the applicable laws and is interpreted in line with the Securities Act.

Preparatory works and court practice are considered important sources in interpreting the laws. Literature refers to these sources as well. Considering the relatively young age of the Finnish Companies' Act, relying on the preparatory works in this paper has been considered appropriate.

1.3 The board of a Finnish company

The mandatory bodies in a limited liability company are the board of directors ("board") and the general meeting of shareholders. Managing director and supervisory board are mentioned in the Companies' Act but are optional. Appointing a supervisory board requires a provision in the articles of association. The board of directors appoints the managing director. There may also be committees who assist the board, however, they don't have independent decision-making capability. It is common to have a management team that takes care of the operative tasks in the company although it does not have a legal status; the management team is not recognised in the Companies' Act.

If there is a supervisory board, its main responsibility is to supervise the administration of the company, which is the responsibility of the board and the managing director. The supervisory board does not have a capability to represent the company. Supervisory boards have become rare in Finnish companies.[10] Most of the Finnish listed companies have a one-tier board structure (board, managing director and general meeting of shareholders). This structure has been considered more efficient and the responsibilities between the governing bodies are clearer. The Finnish government adopted a resolution on 3 November 2011 outlining the objectives and principles for the state's ownership policy. The view on supervisory boards is that state-owned companies might have them if the company carries out a specific government task or where the government interest involves a strategic purpose.

According to Chapter 5 Section 2(1) of the Companies' Act, the general meeting of shareholders shall make decisions on matters that fall within its competence by virtue of the Companies' Act whereas the general competence lies with the board.

[8] The Securities Market Association (http://cgfinland.fi/en/) is a body established by the Confederation of Finnish Industries, NASDAQ OMX Helsinki Ltd and Finland Chamber of Commerce. Its goal is to strengthen the self-regulation in order to ensure that the companies participating in the securities market operate according to consistent rules and principles.

[9] The Takeover Panel (http://www.yrityskauppalautakunta.fi/yritys_eng) is a body that bases itself on the Securities Market Act, which mandates the Panel to issue recommendations and statements applicable in Mergers and Acquisitions and is meant to comply with the directive 2003/71/EY, articles 9,11 and 12. The tasks and powers of the Takeover Panel are not meant to overlap with those of The Finnish Financial Supervisory Authority ("FSA"). Although the two cooperate, the FSA does not have a representative in the Panel.

[10] Out of a total of 119 companies whose main listing is in Helsinki, only five have a supervisory board.

2 The concept of 'company director' in Finland

2.1 *De iure* directors

2.1.1 Requirements to become a *de iure* director

The board, managing director and supervisory board form the management of a company and are subject to the Companies' Act's provisions about management. Although a management team is a common body in large companies, it is not recognised in the Companies' Act and its members are not part of management from the Companies' Act point of view. A management team is also not registered at the Trade Register. A management team assists the managing director in the performance of his or her duties.

If a listed company has a management team, its composition, duties and information on its members shall be disclosed on the company's website.[11] Of the three management bodies mentioned above, only the board is legally required. For the purposes of this paper, unless specifically stated otherwise, "a director" refers to a member of the board.

The board is appointed by the annual general meeting of the shareholders ("AGM"). Less than half of the board members can be appointed by a specific group, such as a certain shareholder or a group of employees. This right must however be explicitly written in the articles.

The board may have between one and five members, unless the articles state otherwise. If there are less than three members, there must be at least one deputy member. A deputy member has the same rights and obligations as a board member, however only when he or she is actively carrying out tasks in the board and taking part in the decision-making.[12] The board appoints one member as a chairperson. In a listed company the term for a board member is one year, starting from the end of the appointing AGM until the end of the AGM that appoints a new director, unless the articles state otherwise. There is no limit to the consecutive terms for a board member, although one of the criteria mentioned in the Governance Code for a Director's independence is that the person may not have been a non-executive director in the company for more than 12 consecutive years.[13]

2.1.2. Who can be *de iure* director

A board member shall not be a minor (under 18 years of age), a person whose capability to decide over his or her own affairs has been limited, or bankrupt. A person sentenced to a prohibition to

[11] Governance Code recommendations 37 and 38.
[12] HE 109/2005, p. 83. It is recognised in the preparatory works, however, that in court practise a deputy member has been found responsible on exceptional grounds (KKO 1997:110).
[13] Governance Code recommendation 15 j).

conduct business is also not eligible as board member. In Finland it is not possible to appoint a company (of any kind) to a board and therefore all members are natural persons. At least one board member must be resident within the EEA, unless the Trade Register has given its approval to deviate from this requirement. What the Companies' Act states about a board member, also applies to a deputy board member in this regard.

The Companies' Act does not list specific qualifications that a board member must have, however the Governance Code recommends that the members have "sufficient and versatile expertise as well as mutually complementing experience". Further: "a director must have the possibility to engage in the company matters in a sufficiently extensive manner."[14] The Governance Code also recommends that both genders are represented on the board.

The Governance Code recommends that the majority of the board is independent of the company.[15] In addition, at least two of such majority shall be independent of significant shareholders. Independence is considered important due to the board's responsibility to oversee the operative management and the possible conflict that might occur between the company and management as well as between the different shareholder groups. The responsibility to monitor the independence lies with the board itself.

2.2 *De facto* and shadow directors

The Companies' Act does not make a categorical difference between a *de facto* and *de iure* director. By definition, only members of the board, supervisory board and the managing director form a company's management.

[14] Governance Code, recommendation 9.
[15] Governance Code recommendation 14.

3 THE SCOPE OF DIRECTORS' DUTIES UNDER FINNISH LAW

3.1 Types of directors' duties

Chapter 1 Section 8 of the Companies' Act sets out that the main duty of the management[16] is to act with due care and to promote the interests of the company. The duty of care is an established concept that bears relevance where a specific provision on liability is lacking. The duty to promote the best interests of the company includes loyalty towards the company and all shareholders.

3.1.1 Duty of care

The preparatory works of the Companies' Act compare the management's relationship with a company to an agent-principal relationship[17] and therefore describe the duties to have a fiduciary nature. The duty of care is assessed in the light of good business judgement. If a decision has been made based on appropriate consideration in the relevant circumstances, the fact that it later appears unsuccessful doesn't categorically constitute liability. The preparatory works also acknowledge that risk-taking is characteristic to business and decisions are typically made in uncertain conditions.[18]

Good business judgement is based on an assumption that management in its fiduciary role is acting on sufficient information and bona fide that such decisions are in the best interest of the company, unless the management does so exceeding its powers, is negligent or breaks the law. Even if a decision would lead to a loss, it does not automatically mean that the duty of care has been breached if the decision was made carefully. The assessment is objective and ignores the actual capabilities of the management but instead measures the actions against a behaviour that would objectively speaking be required from a careful individual in that specific situation. Omitting to act may also be considered a violation of the duty of care. A duty to act carefully is emphasised if the decision involves a higher risk and when the opponent is a related party.[19]

3.1.2 Duty of loyalty

Promoting the interests of a company includes a requirement of loyalty towards the company and its shareholders. The company's interests can be considered equal to those of the shareholders, as a company's purpose is to generate profits for the shareholders.[20] Therefore the requirement of loyalty includes the equal treatment of all shareholders, even in cases where a director has been appointed by a group of shareholders or, more commonly, where the director has been nominated as a

[16] The term management is used as described in the Companies' Act and includes the Board, Supervisory Board and managing director.
[17] HE 109/2005 p. 194.
[18] HE 109/2005 p. 41.
[19] Related party is defined in Chapter 8 Clause 6 of the Companies' Act; if one party controls the other or if one party otherwise has significant influence in the financial and business decision making of the other. The interpretation is meant to equal the definition of a related party in the IAS 24 standard.
[20] Companies' Act Chapter 1 Section 5

candidate by one or more shareholders. A director may not act only for the benefit or in the interest of that group but instead needs to take into account all shareholders equally. While business judgement rule provides some room for unsuccessful decisions, the same does not apply to the duty of loyalty. According to the preparatory works, if a related party benefits at the cost of the company, shareholder or a third party, normally the decision involves at least negligence.[21]

The principle of equal treatment of the shareholders is one of the main principles of the Companies' Act and is specified in Chapter 1 Section 7; unless the articles of association stipulate otherwise, a company's shares provide equal rights. The general meeting of shareholders, board or supervisory board may not make a decision, which would benefit a shareholder at the expense of another shareholder or the company. The purpose of this provision is to protect the minority shareholders and it is typically, but not exclusively, applied in situations where assets are distributed.

The applicability of the general principles is secondary in relation to the specific stipulations of the law, however, even if the formal requirements of the law would be fulfilled, a conduct can be considered inconsistent with the principle and therefore a breach.[22]

3.1.3 General duties of day-to-day management

Chapter 6 Section 2 in the Companies' Act sets out the general duties of the board of directors to see to the administration of the company and appropriate organisation of its operations and to be responsible for the appropriate arrangement of the control of the company's accounts and assets. This covers a wide range of duties that are bound to change over time. According to the law proposal, the board is responsible for duties that are not specifically assigned to the general meeting of shareholders or supervisory board, if it exists. Thus, if there is a managing director, the executive management of the company falls into his or her responsibility. If – and only if – there is no managing director in a company, the executive management also falls into the board's responsibility. The preparatory works explain the general wording in the law by stating that due to the number of different fields and industries in which the companies operate, it would not be possible to specify the duties in such a way that would fit them all and that would survive the changing times.[23] In effect, the managing directors typically play the most important role in running Finnish companies. Even in large corporations, the board meets relatively infrequently;[24] this highlights the rather limited role of the board in managing the company's operations.

The managing director is responsible for the day-to-day management of the company and acts under the instructions and orders of the board. The Companies' Act specifically states that the managing director must ensure that the accounts comply with the relevant laws and the financial affairs are appropriately organised. Although the managing director takes responsibility of a part of duties otherwise falling under the remit of the board, it should be noted that any large-scale strategic

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[21] HE 109/2005 p. 195.

[22] Heikki Toiviainen has pointed out that cases where an act would have been considered null and void specifically based on the general principles in the Companies' Act are rare (Heikki Toiviainen: Suomen Uusi Osakeyhtiölaki: kilpailukykyinen osakeyhtiölainsäädäntö 2000-luvun yrityksille 1800-luvun sääntelyllä? In Business Law Forum 2006, pages 25-67).

[23] HE 109/2005, p. 79.

[24] For example, a large company like KONE (KONE Oyj), with sales of more than 5.2 billion EUR in 2011, holds only six regular board meetings per year; see KONE Annual Report 2011, p 56 (available at: http://www.kone.com/corporate/fi/Sijoittajat/raportit/vuosikertomukset/Documents/KONE_FS_2011_www_linked_en.pdf; last accessed 8 December 2012). Another large company, Finnair Oyj (turnover 2.3 billion EUR), held nine meetings in 2011; see Finnair Annual Report, p 74 (available at: http://www.finnairgroup.com/linked/en/konserni/Financial_Report_2011.pdf; last accessed 8 December 2012).

decision[25] would nevertheless remain with the board. The Governance Code recommends that the terms and conditions applicable to the managing director are specified in the managing director's service contract. If there is a supervisory board, its main duty is to supervise the administration of which the board and managing director are responsible for.

3.1.4 Adherence to other regulatory laws

In addition to the general duties in the Companies' Act, the directors must ensure that the company adheres to other laws applicable to the company; for example the Securities Markets Act, employee safety regulations, environmental laws and the various tax laws. A listed company is also subject to certain corporate governance rules as mentioned earlier.

The Securities Markets Act provides a specific example of a listed company's duty to publish its annual report and financial statements together with a report of its government and control systems (Corporate Governance Statement). The Governance Code further specifies what information this statement needs to include. Another example is the Takeover Code, which sets out obligations to the board regarding public takeover bids. The Takeover Code is issued by the Finland Chamber of Commerce under a specific mandate given in the Securities Markets Act.

3.1.5 Division of duties between the board and members

The Companies Act provides a possibility to the company to specify the duties of the directors in the articles of association, although such provisions are not very common in practice.

In order to ensure as efficient corporate governance as possible, the board may consider it appropriate to divide duties between the individual members. The Companies' Act does not provide specific guidance on this. The articles of association may include some stipulations (as long as they don't deviate from the obligatory regulations in the law) but the board may simply agree on a division of tasks between themselves. The preparatory works mention that division of tasks may be relevant when assessing the extent of the directors' liability: it might result in one director bearing more responsibility than another.[26] For example, if the liability concerns a matter belonging to a committee where one of the directors is a member. The Governance Code includes recommendations on board committees. Although the directors may delegate their tasks, a committee will only have an assisting role, while the decision-making powers and the liability remain with the directors.

Under Chapter 6 Section 2 of the Companies' Act, the board has a general right and obligation to act. The powers of the board may however be assigned to the shareholders:

- By way of taking a provision to the articles of association, in which case the transfer may concern only matters that fall into the general powers of the board and the managing director;
- The board can, at its discretion, assign a matter belonging to its or the managing director's general powers to the general meeting of shareholders; or
- Unanimous shareholders can resolve over an individual matter belonging to the general powers of the board or the managing director.

[25] Considering the company's business, decisions that have far reaching effects or are unusual, belong to the Board of Directors; typical examples of such decisions are changes to the company's business, investments and divestitures.
[26] HE 109/2005, p. 82.

The board can, in an individual case or based on a provision in the articles, resolve a matter belonging to the general powers of the managing director. The board will in that case be responsible for the resolution, however if that resolution would turn out to be against the articles or law, the managing director might be held liable on the grounds of executing it. If a matter would fall under a specific duty of the managing director, he or she would remain responsible even if the board would resolve over such specific matter.

Transfer of the powers to the general meeting of shareholders does not have an effect on the capacity of the board or the managing director to represent the company. Unless there is a specific stipulation in the articles, the general meeting of shareholders is not obliged to resolve in the matter transferred to it. The wording of the Companies' Act specifies certain duties to be explicitly the board's responsibility. These duties cannot be assigned to the general meeting of shareholders. As an example, if the board of a public company notices that the equity falls under half of the share capital, it must draw up financial statements and an annual report to clarify the financial state of the company.[27] If the board of a private or public company notices that the company has negative equity, it shall without delay notify the loss of the share capital for registration with the Trade Register.[28]

In practice the division of powers between the board, managing director and the general meeting of shareholders depend on the organisation of the governance and management of the company, the directors themselves as well as the size of the company and its operations. This has been made possible by a flexible Companies' Act.

[27] Companies' Act Chapter 20 Section 23 (3). This rule applies specifically to public companies.
[28] Companies' Act Chapter 20 Section 23 (1).

4 LIABILITY FOR BREACH OF DUTY

The Companies' Act includes specific provisions regarding liability for damages (Chapter 22) and penalties (Chapter 25), which concern the management's liability towards the company, shareholders and third parties such as the debtors based on the Act itself. This does not mean that liability could not materialise on grounds of other laws, which obviously will be assessed separately and in the light of the relevant law.

Liability is typically divided into contractual and non-contractual. There is no general law in Finland that would govern contractual liability, however non-contractual liability is covered by the general law of liability. The Companies' Act includes a specific set of norms that regulate the liability of the management, shareholders and auditors towards the company, shareholders and third parties. As the relationships are considered close to contractual situations, the liability based on Companies' Act is closer to those of contractual than non-contractual liability. As an example, the general law of liability rarely leads to compensation of pure financial loss whereas based on Companies' Act this would typically be the case.

Based on the preparatory works of the Companies' Act, the definition of a director subject to the liability rules in Chapter 22 and the definition of a director in light of his or her duties in Chapter 6 would seem to be similar and would therefore apply only to those who have in fact been appointed to the relevant position. Management, in both chapters would mean the board, managing director, and supervisory board.[29]

Section 1 (2) refers to liability in violation of provisions of the Companies' Act other than the general duty of care. It should be noted that failure to comply with other laws than the Companies Act may be seen as a breach under this section if the obligation set out in the Companies Act would refer to another law that specifies that obligation.

4.1 Duty of care: conditions for liability

Chapter 22, Section 1 (1) of the Companies' Act states that a member of the board, supervisory board and the managing director shall be liable for the loss that he or she, breaking the duty of care referred to in Chapter 1 Section 8, has in his or her office deliberately or negligently caused to the company. Section 1 (2) states that a member of the board, supervisory board and the managing director shall be liable for the loss that he or she, by breaking other provisions of the Companies' Act, has in his or her office deliberately or negligently caused to the company, shareholder or third party.

The law does not provide much help in interpreting the phrase *"in his or her office"*. Some attempts have been made in the literature, however as Kurkela has put it, trying to hold a director liable for acts beyond his or her capacity as a director or not related to the company seems absurd.[30] A director present at board meetings would obviously be considered in office, however, for example, information he or she learns about outside the meeting leads to a duty for him or her to bring it to the attention of

[29] HE 109/2005, p. 78 and 194.
[30] Matti Kurkela: On the Liability of Directors in Finnish Corporations: to whom and for what?, JFT 1/2003.

the board if that information is relevant for the business of the company. According to the Supreme Court case KKO 1997:110, even a deputy director may be liable for damages. This is the case even where the deputy director did not participate in the decision-making, provided that he or she neglected the fiduciary duty e.g. by not disclosing to the board the essential factors related to the decision that he or she was aware of.

When discussing the duty of care, both literature and the preparatory works of the Companies' Act refer to the Anglo-American business judgement rule.[31] The way duty of care is considered in Finland would seem to lead into similar conclusions. If the board has based its decision on information that is, considering the circumstances, sufficient and appropriate, it won't be held liable. It is important to note that the business judgement rule only applies to duty of care and not to breaches of other provisions of the Act.

Section 1 (3) discusses the burden of proof which is different in the cases when the loss has been caused by a violation merely of the principles referred to in chapter 1, such as the duty of care or equal treatment of shareholders, and in the cases where the violation concerns specific provisions of the Companies' Act. The burden of proof concerning duty of care lies normally with the director but not in cases where the director is accused of breaching only the general principles (equality, loyalty).[32] Without this exemption the directors are thought to end up in unreasonable situations.[33] The reversed burden of proof only applies to claims of negligence in complying with the Companies' Act. In the cases of intent or gross negligence, the burden of proof lies with the plaintiff.[34] If the case is based on other law than the Companies' Act, the burden of proof will need to be assessed accordingly.

4.2 Exemptions and limitations

The directors' liability towards the company can be limited in certain circumstances in the articles, unless the liability is caused by breaking mandatory provisions that can't be bypassed or if it is based on gross negligence or intent. The limitation requires unanimity among the shareholders and it must be registered in the Trade Register, which leads to a conclusion that this type of limitation is either taken in the articles at the time the company is incorporated or will be possible later only in companies with small numbers of shareholders.

One of the agenda items at the annual general meeting is a discharge to the board of directors, managing director and to the supervisory board (if the two latter exist). Granting a discharge is basically a waiver of claims towards the directors. However, Companies Act Chapter 22 Section 6 (2) states that a discharge is not binding unless the information given to the general meeting of shareholders regarding the board resolution or action, which is the basis of the liability, has been materially correct and sufficient. If the company is bankrupt or under restructuring administration, the relevant administrators can file a suit as well if the proceedings have started within two years from the board's resolution or action.

The nature of the discharge raises the threshold of 'materially correct and sufficient information'. To

[31] HE 109/2005, p.195 and Jukka Mähönen, Antti Säiläkivi, Seppo Villa: Osakeyhtiölaki käytännössä, 2006.
[32] For example where damage has been caused by an act that has benefitted a related party (definition equals that in the IAS standard).
[33] HE 109/2005, p.195.
[34] HE 109/2005, page 196.

avoid a claim, this information must have been specifically provided to the annual general meeting that resolved over the discharge. A part of this information is the auditors' statement, which includes a view on whether the directors may be granted a discharge.

4.3 Insurance against liability

Directors' and Officers' liability insurance has become common in Finland and the increase of laws and regulations together with the market climate have underlined their relevance. Although the Companies' Act does not include such provisions, directors operating in certain fields may have a statutory obligation to take insurance.

A comparison between the general terms and conditions of D&O insurances offered by two major insurance groups[35] in Finland leads to a conclusion that a standard insurance:

- Is applicable to formally appointed directors (i.e. excludes *de facto* directors);
- Is valid in Finland and applicable to claims considered under Finnish law. This might lead to practical problems in cross border situations;
- Covers a loss that the insured person has caused in his or her office as a director and for which the insured is liable based on the Companies' Act or another law stipulating a director's liability;
- Covers only financial loss (i.e. no damages to a person or property). This is in line with the statutory liability based on Companies Act, which rarely extends to damage caused to a property or person;
- Excludes environmental damages and losses caused to group companies;
- Does not cover intent or gross negligence;[36]
- Does not cover contractual loss that is merely based on the relevant agreement and would otherwise not materialise, i.e. the company has accepted a higher liability than what its statutory liability would have been. Although the limitation is justified due to the fact that the liability can be materially extended by a contract, it will most likely remain theoretical, as the directors are normally not responsible for the contractual duties between the company and a third party; and
- Includes a deductible and a cap of compensation.

D&O insurance has been considered as an important incentive in recruiting non-executive directors to the board, especially if they are foreign nationals.

Ari Savela has discussed the liability insurance from the company law perspective[37] and concluded that the board can resolve over taking standard liability insurance for itself and the managing director. Savela argues that there are no stipulations in the Companies' Act preventing a company from taking

[35] Pohjola Bank Plc; www.pohjola.fi, Tapiola Group; www.tapiola.fi
[36] Case KKO 1997:103; question about an auditor's gross negligence while conducting an audit and whether the insurance payment should be therefore denied. The court mentions that defining gross negligence and the line between negligence and gross negligence is not straightforward. The considerations in cases of liability and liability in the light of insurance might differ. The law of liability has considered an action to be negligent when it approaches intentional and therefore indifferent about the consequences. The court further states, while considering the amount of the insurance payment or even its denial, that on one hand, a liability insurance is taken typically to cover the cases at hand, however, an insurance shall not lead to a conscious risk taking at the expense of the insurance companies. Therefore, in the light of the purpose of liability insurance, only an act or omission that shows clear carelessness in his work shall be considered gross negligence. From the case it seems evident that omission to fulfil liability that are based on law would constitute clear carelessness.
[37] Ari Savela, Yritysjohdon vastuuvakuutus in Defensor Legis 1998.

or from paying for insurance for its directors. Because insurance is not directly a matter of a director's compensation, it would not need to be handled at the general meeting of shareholders. Savela admits, however, insurance does have an indirect link to a compensation, as a director may wish a higher compensation if his or her package doesn't include insurance. If the general meeting of shareholders has resolved over a higher compensation for the directors based on the fact that insurance is not provided, the board can't overrule this by granting an insurance to itself. Chapter 6 Section 4 of the Companies' Act stipulates that a director may not take part in handling an agreement between himself and the company, or an agreement between the company and a third party where the director would be expected to gain a material benefit contradictory to the company's interests. Savela's view is that because it would be difficult for a director to misuse insurance in order to gain benefits, the board is not conflicted to decide over directors' liability insurance having standard terms.

4.4 Consequences of liability

The Companies Act does not include provisions about limitation of the directors' liability nor how the liability should be considered between the individual board members, but instead makes a reference to the general law of liability. The general principle enables reconciliation, if a liability is considered unreasonable taking into account the financial circumstances of the person liable and the person suffering the loss as well as other circumstances. In these cases the compensation might be limited. Reconciliation is not possible in the cases of intent or gross negligence unless there are special reasons.[38]

The general principle in the general law of liability is that if more than one person is liable for the same loss, they are jointly and severally responsible.[39] As the Companies' Act does not regulate the division of tasks between the directors, the responsibility of the board and the liability of the duties are considered joint. The board makes resolutions collectively as one body. There have been views in the literature, however, that the division of tasks among the board members would have relevance in how the liability is divided between them and therefore the amount of compensation each member is obliged to pay may vary.[40]

Liability is always based on negligence or intent. If a director is actively against certain resolution or action, he or she might be acquitted. As the directors have an obligation to act, being passive and not taking part in the board is not considered to free the members from liability.[41]

[38] Chapter 2 Section 1(2) in the general law on liability.
Case KKO 2000:106; the board had omitted to take action in the company's deteriorating financial situation and the question was about the causal relation to the debtor's damages. Two of the initial three board members had resigned before the third board member, who was also the company's managing director, had committed a fraudulent act, which was further damaging the debtor's position. The court found that, although the two were not responsible for the damages caused by the criminal action of the managing director, they should have been aware of the financial situation of the company while they were in office and should therefore started an administrative process with an external administrator. Referring to the general law on liability, the two directors were sentenced to pay a smaller amount than the managing director.
Case KKO 2001:111; chairman of the board in an association (this case is considered relevant as the applicable laws are comparable to those applicable to a limited company and its directors) was held liable for a loan he had granted to a private person against the law, the association's articles and without an appropriate resolution made by the board. The borrower was unable to pay back the loan and so was the guarantor. The chairman was sentenced to pay the amount of the loan back to the association. Interesting in this case was also the fact that the chairman was not indemnified by the earlier discharge, on the grounds that the information provided to the association's meeting of members was not sufficient, correct or complete.
[39] Tort liability Act Chapter 6, Section 2.
[40] Jukka Mähönen, Antti Säiläkivi, Seppo Villa: Osakeyhtiölaki käytännössä, 2006, and HE 109/2005, p. 82.
[41] Reference is made to the Supreme court case mentioned above, KKO 2000:106.

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 The meaning of 'vicinity of insolvency'

When the company finds itself in financial difficulties, the decision on the course of action is basically determined by whether there is hope of recovery or not, in other words whether the over-indebtedness is temporary or permanent. According to the definition in the Bankruptcy Act, the key indicators of over-indebtedness are inability to keep up with the payments when they fall due and not qualifying for new financing. The assessment is not only based on current time but has a forward-looking aspect. The liability may exceed assets, however if the company is paying its invoices when they are due, there is no grounds for bankruptcy.

Although literature does not recognise a concept of a "twilight zone" or equivalent, and there is no requirement to liquidate at given circumstances, in light of the duties of the board, it is fair to conclude that an emphasised duty of care should be applied when there are signs of financial distress. A close example can be given from the conditions concerning distribution (by way of dividend, loan etc.) of assets to the shareholders or third parties. The Companies' Act determines when such distribution is acceptable and prohibits it if it is known or should be known at the time of the distribution that the company is insolvent or that the distribution will cause insolvency.[42] An illegal distribution may cause it to be reversed provided there is a loss and causality.

5.3 Newly arising duties

The directors' duty of promoting the best interests of the company includes a requirement of loyalty towards all the shareholders equally. One of the specific duties of the directors is to monitor the financial state of the company. Chapter 20 Section 23 in the Companies Act specifies the actions that need to be taken in a situation where the equity has decreased to a certain level in respect of the share capital: if the company's equity becomes negative, the board must without delay make a notification to the Trade Register, which can be removed if the company shows a balance sheet and supporting evidence of the equity being more than half of the share capital.[43] In a public company the board must act if it notices that equity is less than half of the share capital. The board must then draw up financial statements and an annual report to ascertain the financial position of the company.[44] These reports must be audited.[45] In addition, Chapter 13 Section 2 of the Companies Act also contains a solvency test for any distributions to shareholders; distributions are prohibited where the company is insolvent or the distribution would cause insolvency. This applies irrespective of whether or not the last audited financial statements show distributable profits.

[42] Companies' Act Chapter 13 Section 2.
[43] Companies' Act Chapter 20 Section 23(1).
[44] Companies' Act Chapter 20 Section 23(3).
[45] At least one of the auditors in a public company must be approved by the Auditing Board of Finland Chamber of Commerce.

If the balance sheet shows that equity is less than half of the share capital, the board shall convene a general meeting of shareholders to consider measures to remedy the financial position of the company.[46] In addition, the board must inform the Trade Register. If the board fails to act, the liability is judged based on the rules in the Companies' Act, which obviously require loss and causality between the action/omission of the board and the loss.

The amount of equity in respect of share capital is primarily assessed based on a balance sheet. A capital loan is considered equity, as well as depreciations and voluntary provisions. If a resale value of an asset is likely to be materially higher than its book value, and the higher value is not considered temporary, the difference can be taken into account in calculating equity. These possible additions to the equity calculation are subject to an underlying duty of care[47] and must be explained in the annual report or notes to the balance sheet.

If the balance sheet shows a decrease in equity as is explained above, the board must convene a general meeting of shareholders. The meeting shall be held within three months from drawing up the financial statements. The general meeting of shareholders shall be provided with all relevant information on the financial state of the company but it is not obliged to make a resolution on the next steps.

The Companies' Act no longer includes provisions on compulsory liquidation.[48] These have been partly replaced by Chapter 20 Section 23 (notification to the Trade Register) together with Chapter 13 Section 2, which prohibits distributions if it was known or should have been known that the distribution would cause the company to become insolvent.

Further, debtor's dishonesty is a criminal offence,[49] which basically covers transactions whereby the company weakens its financial position in such a way that it causes or worsens insolvency. The difficulties are or should have been already known. Stalling the decision of a restructuring or bankruptcy might also qualify as an unjustified increase of liability and is specifically prohibited.

If there is hope for a recovery, restructuring under the Restructuring of Enterprises Act[50] can be used to restore liquidity and to avoid bankruptcy but not to keep the company alive artificially. The company itself or its creditors can initiate the proceedings. An independent administrator appointed by the court will in this case prepare a report of the company's debts, assets and other commitments as well as other matters that have an impact on the financial position of the company, supervise and monitor the company's activities, to the extent necessary to see to an audit of the activities undertaken before the proceedings, if appropriate, reverse transactions, prepare a restructuring programme and certain procedural matters. The restructuring programme aims to give a favourable result for the creditors, however it should at the same time be realistic and motivating from the company's perspective.

[46] In a private limited liability company there is no legal obligation to convene a general meeting of shareholders in these circumstances.
[47] Underlined duty of care means in this case that a possible tax impact on the depreciations and provisions must be taken into account in the calculation and the increase of asset value should be based on an assessment of an external expert. A sale price shall be presented net of expected sales costs.
[48] The preparatory works (HE 109/2005, p. 29) explain the reason for the change: the previous provisions in the Companies' Act on compulsory liquidation were not in line with the insolvency law because the former was based on a formal status of the balance sheet instead of an assessment of the company's liquidity. Omitting to act often lead to the directors' strict liability resembling a direct responsibility of the company's debt. The previous law was based on an assumption that share capital would protect the debtors and would operate as a buffer, however in practise the categorical compulsory liquidations were not benefitting the debtors.
[49] Criminal Code Chapter 39 Section 1. A company may become subject to a fine between 850 and 850 000 euro.
[50] 25.1.1993/47

In complex cases there can be a creditor committee that assists and monitors the administrator. Although the board and managing director continue in office, their powers will be limited; activities that are not considered in the ordinary course of the company's business are restricted and subject to the administrators consent (taking on new debt, transfer of assets, terminating material contracts etc). The board and managing director maintain their capability to represent the company. The administrator does not have this capability in his or her role without a specific Power of Attorney.

If there is no hope for a recovery and the company is facing liquidation, for example by way of a company restructuring or bankruptcy, the board basically hands over its tasks to an external administrator.

6 Enforcement of Duties

6.1 Who has standing to sue

6.1.1 The company as plaintiff

Primarily, it is the board who decides whether or not a suit is filed on behalf of a company. This task is considered part of the board's general duties and the decision is subject to the same consideration of duty of care and loyalty as described earlier. The Companies' Act specifically provides that besides the board, the decision of filing a suit can also be done by the general meeting of shareholders,[51] which is recommended when the question is about liability of the board itself. Delegating the matter to the shareholders may be necessary due to Companies' Act Chapter 6 Section 4, which prohibits a member of the board to participate in decisions over a matter that concerns the company and himself. A board member may also be considered biased to resolve over a liability case that concerns his or her fellow director if there is a question about whether he or she has omitted to monitor his or her fellow director.[52] It should also be noted that a seemingly impartial board may jeopardise itself if its resolution favours the person liable at the expense of the company.

A decision over a lawsuit can also be brought to the general meeting of shareholders for a decision based on a specific provision in the articles of association. Absent such a specific clause in the articles, shareholders can request a matter to be resolved at the general meeting of shareholders, if they do so unanimously. However even a single shareholder can make such demand if the shareholder so demands in writing from the Board of Directors well in advance of the meeting, so that the matter can be mentioned in the notice. The resolution of the general meeting of shareholders requires a simple majority.

It is important to keep in mind that, whether the deciding body is the board or the general meeting of shareholders, the decision must be based on what is in the best interest of the company and thereby in line with the fiduciary obligations of both the board and general meeting of shareholders. If for example the case would only have a small possibility to succeed because of legal uncertainties, the opponent's insolvency etc., the sensible decision might be to drop the case.

6.1.2 The shareholders as plaintiffs

6.1.2.1 In the name of the company ('derivative action')

A shareholder can, alone or together with another shareholder, file a suit in his or her own name but where he or she demands compensation to the company (derivative claim). This is possible if;

- It is likely that the company itself is not going to use its own right to sue, and

[51] Companies' Act Chapter 22 Section 6
[52] Jukka Mähönen, Seppo Villa: Osakeyhtiö III, Corporate Governance, 2010.

- The plaintiff(s) hold at least 1/10 of all shares OR it is proven that a decision not to use the company's own right to sue would violate the principle of equality.[53]

The first condition to the shareholder's claim is that the company itself is not going to act. This is obvious if the board has made a resolution not to file a suit or the general meeting of shareholders have resolved over a discharge. If the matter hasn't been discussed at all, it might be difficult to prove what the likelihood of the end result would have been. The second condition is fulfilled automatically if shareholders having 1/10 of all shares support the case. Shareholder(s) with fewer shares must also show that the decision to remain passive would be a violation of the equality principle. It is irrelevant whether one shareholder has benefitted from the passivity at the expense of another; the benefitting party may as well be an outsider.[54]

The Companies' Act specifically mentions that a shareholder has no right to a compensation for a damage caused to the company.[55] The plaintiff shareholder bears the burden of proof. Even if the company would decide to start a case later, that would not affect the shareholder's right. A shareholder tries the case in his or her own name and bears the litigation costs if he or she loses.

A suit against a board member, which is based on Chapter 22 of the Companies Act, must be filed within five years after that accounting year during which the wrongful decision was made.[56]

6.2 Criminal and administrative sanctions

6.2.1 Companies' Act

The unofficial translation of the Companies' Act by the Ministry of Justice, translates the criminal sanctions as a company law offence and a company law violation. Both must involve intent. While the number of cases isn't very high, the relevance of these provisions becomes apparent when assessing a potential liability of the directors. A liability for a financial loss according to the general law of liability requires a material reason or a Criminal Code. When it comes to a company, a loss is typically financial and therefore the applicability of the general law of liability increases in these circumstances.

Company law offence means:

- Violating the prohibition on trading of the securities of a private company under the Securities Markets Act;
- Violating certain provisions concerning drafting of an auditors' report;
- Acting as a front[57] for a third party for the purposes of circumventing the voting restrictions in the Companies' Act or in the company's articles of association; or
- Violating the provisions on protection of the shareholders or creditors by distributing assets against the provisions of the Companies Act.

[53] Companies' Act Chapter 1 Section 7.
[54] HE 109/2005 p. 200.
[55] Companies' Act Chapter 22 Section 7 (4).
[56] Companies' Act Chapter 22 Section 8.
[57] Ari Savela, 'Osakeyhtiörikos- ja rikkomus' (2009) 1 DL 1,6 – "a front" is normally a person acting for an anonymous assignor.

Sentence can vary between a fine and one year imprisonment.[58]

Company law violation means;

- A failure to keep or keep available a share register or a shareholder register;
- A failure to keep the minutes of the general meeting of shareholders available to the shareholders;
- Non-compliance of the notification of the rights of squeeze out and sell out to the company according to Chapter 18 Section 2 of the Companies' Act; or
- Non-compliance of the provisions of the Companies' Act on drawing up the financial statements, annual report or the consolidated financial statements or on submission of the final accounts or settlement relating to a merger, demerger or liquidation of the company.

The sentence is a fine.[59]

The literature[60] has criticised the criminalisation in the Companies' Act by pointing out that the provisions cover a wide range of circumstances, which leave plenty of room for interpretation. This together with the fact that a minor offence might lead to a sanction increases the risk of directors' liability. Further, criminal acts are usually excluded from insurance.

6.2.2 Criminal Code

The Criminal Code on misuse of an entrusted position[61] is a sanction for the breaking of a fiduciary duty of loyalty. If a person is entrusted with financial or legal assignments and he or she deliberately misuses this position by taking an action he or she is not entitled to or partly or fully omits his or her task and thereby causes harm to the assignor's business, he or she may face a sentence between a fine and two years of imprisonment. The clause applies to anyone who takes care of someone else's financial or legal affairs and has the right to make decisions independently on matters that will bind the assignor or independently look after the assignor's legal or financial interests; i.e. typically a board or supervisory board member and a managing director. The applicability is assessed based on the *de facto* role of the person and therefore extends to a management team as well as mid-management, provided that they are taking care of tasks that fit the description. A deliberate misuse means that the assignee must be aware of the fact that his or her action or omission is not in line with the assignor's wishes and that it is likely to cause a loss.[62]

A natural person, specifically in light of the current topic, a board or supervisory board member or a managing director as well as a *de facto* director, may become prohibited to conduct business. Such person may no longer act as a director in a company or directly or indirectly acquire a majority in a business.

A judge may rule over a prohibition to conduct business for a minimum of three and maximum of seven years, if:

[58] Companies' Act Chapter 25 Section 1.
[59] Companies' Act Chapter 25 Section 2.
[60] E.g. Ari Savela: Osakeyhtiörikos- ja rikkomus (2009) 1 DL 1,6.
[61] Criminal Code Chapter 36 Section 5.
[62] If for example the Board believes it is making a right decision at the time but later on appears unsuccessful, the Board will not become liable under this clause.

- A person conducting the business has materially omitted legal obligations that follow from that business, or
- A person conducting business is guilty of a criminal offence which can't be considered minor.

Typically, a director would have caused a decrease in the company's assets or increased its liability so that the chances for the debtors to collect their receivables become less. The "legal obligations" are limited to statutory obligations and therefore exclude agreements, and for example a company's articles of association.[63]

According to Criminal Act Chapter 29 Section 4, directors shall be criminally liable for tax violation if the company has failed to pay its public taxes and duties, such as withholding taxes, VAT, certain insurance premiums or employer's social security contributions for a reason other than insolvency. If found guilty of tax violation, the directors are sentenced to pay the neglected taxes in the same criminal proceedings. Court practice is strict in the interpretation of when the failure to pay was for a reason other than insolvency. The Supreme Court stated in its case KKO 1996:35 that the company was not considered to be insolvent when it failed to pay the withholding taxes and social security payments for a long time but at the same time continued its business operations and made payments to other creditors and thus made to a considerable extent possible the continuation of the business operations by neglecting the employer duties. The neglect had lasted four months before bankruptcy (the Supreme Court considered this to be a long time before bankruptcy). In addition to a fine the sole director of the company was sentenced to pay the neglected taxes and fees.

A company itself can become liable for a criminal action. This is a special kind of liability caused by people acting on its behalf. A company can become subject to a fine, if, a crime has been committed in its business; if a member of the board, supervisory board or managing director, including a *de facto* director, general meeting of shareholders and the auditor, has been involved in a crime, has allowed a crime to be committed or has omitted to prevent it.[64] This means that a provision elsewhere in the Criminal Code must list such fine as a consequence of breaching the said provision (for example Chapter 16 Clauses 13-14 about bribery, Chapter 17 about involvement in organised crime, Chapter 29 Clauses 1-2 about tax fraud).

[63] The prohibition has mainly been given as a consequence of a criminal offence, for example tax fraud. The purpose of the prohibition is to stop inappropriate business conduct, which is considered detrimental to a healthy competition in the market place.

[64] As has been explained earlier, the Board is responsible for setting up an appropriate control mechanism in the company. A failure can lead to insufficient reporting and incapability to monitor the business, which in turn may cause liability to the company even if the Board would have been unaware of the criminal conduct.

7 CONFLICT OF LAWS

7.1 Classification under Finland's private international law

7.1.1 Company law

According to the international private law principles applied in Finland, the laws of the country where the company is registered apply to the company's internal affairs. This is reflected in Chapter 1 Section 1 of the Companies' Act: "This Act applies to all limited liability companies registered in accordance with Finnish law". The Companies' Act is indifferent to where the management is based or where the main business of the company is run.[65] What this basically means is that the matters falling under company law are assessed according to the law of the country where the company is registered.[66]

7.2 Application of the relevant private international law rule

The Companies' Act does not, however, stipulate the international jurisdiction of Finnish courts. Although a liability case (based on the Companies' Act) against a board member would normally be handled at the court where the company has its domicile, if the board member is not residing in Finland, from Finland's commitments in international agreements it may follow that he or she can't be brought into court there.

The principle following from the Council Regulation (EC) No 44/2001 of 22 Dec 2000 ("Brussels I") on jurisdiction and the recognition and enforcement of judgements in civil and commercial matters is that jurisdiction is to be exercised by the EU country in which the defendant is domiciled, regardless of his or her nationality.

The situation changes, however, if there is an agreement on jurisdiction. Article 23 of Brussels I states that if the parties, one or more of whom is domiciled in a Member State, have agreed that a court or courts of a Member State are to have jurisdiction to settle any disputes which have arisen or which may arise in connection with a particular legal relationship, that court or those courts shall have jurisdiction. Literature[67] has referred to Powell Duffry case[68] to conclude that a clause in the articles of association of a Finnish company shall be considered as such agreement and that it would be binding to all shareholders. A company can, therefore disregard Chapter 24 Section 1 in the Companies' Act about competent courts by granting jurisdiction to a foreign court in its articles of association. Such a clause can't, however, automatically be considered a valid arbitration agreement, which is subject to The Convention on the Recognition and Enforcement of Foreign Arbitral Awards (The New York Convention).

[65] This might be different for example from the tax law point of view.
[66] Even if a company would be fully owned by Finnish shareholders and its management would be based in Finland, it would not suffice for the Finnish Companies' Act to apply.
[67] Jukka Mahonen, Seppo Villa, Osakeyhtio III, Corporate Governance 2010.
[68] Case C-214/89.

DIRECTORS' DUTIES AND LIABILITY IN FRANCE

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CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in France

French company law is derived from different statutory sources:

- Articles 1832 to 1844-17 of the Civil Code set out general rules applicable to every company (civil or commercial) unless otherwise provided for by statute.[1]
- The rules governing each type of commercial company can be found in the French Commercial Code, which is divided into a legislative and a regulatory part.[2] The provisions of the Commercial Code (*Code de Commerce*) on companies originate from law n°66-537 of 24 July 1966 on commercial companies.[3] This law was incorporated into the French Commercial Code in 2000.
- The rules related to securities and capital market regulation are laid down in the Monetary-Financial Code (*Code monétaire et financier*), which is also divided into a legislative and a regulatory part.

1.2 Corporate landscape in France

1.2.1 Company types in France and ownership structure

Several types of company exist under French law:

- A public limited company (*société anonyme: SA*)[4] is a company whose (minimum) capital is divided into shares (*actions*) and is formed by shareholders who only bear any losses up to the amount of their contributions. The number of shareholders may not be less than seven. The shareholders do not have the status of commercial persons.
- The simplified stock company (*société par actions simplifiée: SAS*)[5] is a separate form but shares many provisions with the SA. It was introduced into French law in 1994 in order to provide for a flexible form of joint stock company, initially for subsidiaries within groups, without reforming the SA itself. The SAS may be incorporated by one or more persons who are liable for its losses up to the amount of their contributions. There is no minimum capital. It allows much greater contractual freedom than the SA to determine the governance structure of the company in the articles of association[6] and the rights of the shareholders. Because this freedom is dangerous for minority shareholders, the SAS is prohibited from offering financial instruments to the public (*titres financiers*) or having its "shares" listed on a regulated market.[7]

[1] Article 1834 of the French Civil Code.
[2] Articles which are part of the Legislative Code are identified as art. L. XXX, whereas articles which are part of the regulatory Code are identified as art. R. or .D.
[3] The Law of 24 July 1966 on commercial companies repealed and replaced the law of 24 July 1867 on companies.
[4] Article L.225-1 of the French Commercial Code.
[5] Article L.227-1 of the French Commercial Code.
[6] Article L.227-5 of the French Commercial Code.
[7] Article L.227-2 of the French Commercial Code.

- The limited partnership with shares (*société en commandite par actions: SCA*)[8] has a (minimum) capital that is divided into shares. There are two categories of partners: the active partners have the status of commercial persons and are jointly and severally liable without limit for the debts of the partnership. The limited partners are liable for the losses of the partnership up to the amount of their contributions. The number of the limited partners may not be less than three.
- The private limited company (*société à responsabilité limitée: SARL*)[9] is formed by one or more persons who bear the losses of the company up to the limit of their contributions. The SARL was introduced in 1925 following the German model of the GmbH (*Gesellschaft mit beschränkter Haftung*). In contrast to the *société anonyme*, the SARL is not subject to minimum capital requirements.[10]
- The limited partnership (*société en commante simple: SCS*) [11] is formed by two types of partner: managing partners (*associés commandités*) have the same status as the partners of a general partnership, whereas limited partners (*associés commanditaires*) are only liable for the debts of the partnership up to the amount of their contribution.
- In a general partnership (*société en nom collectif: SNC*)[12] all partners have the status of commercial persons and are jointly and severally liable for the debts of the partnership.

More than 80 % of French companies are private limited companies. The number of simplified stock companies has steadily increased since the creation of this type of company. The SAS is a great success. An analysis of the ownership structure of French companies shows that ownership remains largely concentrated.[13] Nevertheless, the number of individual (mainly institutional) shareholders has increased. This increase is seen as a result of the privatisation of major companies.[14] Another feature of the ownership structure of French companies is the importance of foreign investors in major French companies (CAC 40) and in French listed companies.

As to French companies (37) which are members of the CAC 40, the foreign ownership level was 42.4 % at the end of 2010.[15]

[8] Article L.226-1 of the French Commercial Code.
[9] Article L.223-1 of the French Commercial Code.
[10] Article L.223-2 of the French Commercial Code.
[11] Article L.222-1 of the French Commercial Code.
[12] Article L.221-1 of the French Commercial Code.
[13] Corporate Ownership Structure and Performance in Europe, Jeremy Grant and Thomas Kirchmaier, Centre for Economic Performance Discussion Paper No 631 April 2004.
[14] Corporate Governance in France, Gerard Charreaux and Peter Wirtz.
[15] Extract from Corporate Governance in France, Gerard Charreaux and Peter Wirtz; J. Leroux, La détention par les non-résidents des actions des sociétés françaises du CAC 40 à fin 2010, Bulletin de la Banque de France • N° 184 • 2e trimestre 2011, p. 93.

The Percentage of foreign ownership in French Companies which are members of the CAC 40

Origin: Bank of France[16]

	2007	2010
Eurozone	16.5%	17.6%
United States	16.5%	14.4%
United Kingdom	3.1%	2.8%
Japan	1.2%	1.5%
Switzerland	1.1%	1.3%
Canada	1.1%	1.3%

As to all listed companies, the ownership level was 41.6 % at the end of 2010. Both percentages have remained rather stable since 2002, fluctuating between 40 % and 46 % for the CAC 40 companies and between 38 % and 42 % for all listed companies.

Some commentators observed:

“The ownership structure of listed companies has gone through major changes for several years. Hence, we observe a strong decline of cross shareholdings which has allowed for a significant increase in the presence of institutional investors, especially non residents. The shareholdings directly controlled by households have also declined. When looking at the companies composing the CAC 40 stock index, the ownership stake controlled by foreign investors exceeded 46 % by the end of 2005. When compared to other leading nations, France appears to be the country with the most international corporate shareholder structure.

This strong presence of institutional investors does not mean however that the latter generally hold controlling capital stakes, since only 11.3 % of the companies as of the end of 2002 had an institutional investor as the main shareholder, whereas the proportion was over 40 % for the United States and the United Kingdom. In fact, Faccio and Lang (2002) and Sraer and Thesmar (2006) show that over 60 % of all listed companies remain under the control of the founding family. It is also worth mentioning that the State nowadays merely controls a marginal capital stake of about 2 % in French listed companies.”[17]

[16] J. Leroux, La détention par les non-résidents des actions des sociétés françaises du CAC 40 à fin 2010, Bulletin de la Banque de France • N° 184 • 2e trimestre 2011, p. 93.
[17] Corporate Governance in France, Gerard Charreaux and Peter Wirtz.

France's securities market is called Euronext Paris. Paris Bourse merged with the Amsterdam, Lisbon and Brussels exchanges in September 2000 to form Euronext NV, which is the second largest exchange in Europe behind the UK's London Stock Exchange. It now belongs to the NYSE Euronext group, the first global stock exchange. As of December 2011, a total of 586 companies were listed on Euronext Paris (excluding investment funds) with a market capitalisation of more than 1 trillion Euro.[18]

1.2.2 Standards applicable depending on the type of company

A distinction is made in French law between companies that have offered their shares for sale to the public and those that have not. However, while the regulation of the company's organisation and operation may differ depending on whether the company is a public or private limited company and its shares are admitted to trading on a regulated market, the rules concerning directors' duties and liability apply to both private and public companies with only minor adjustments.

No specific regulation applies to companies governed by the public sector, as far as directors' duties and liability are concerned.

Important features of corporate governance of public limited companies derived from the French Commercial Code are the following:

Article L. 225-23 of the French Commercial Code provides that one or more directors shall be appointed from among the employee shareholders if the employee shareholdings exceed 3 % of the corporate capital in companies whose shares are listed on a regulated market. Furthermore, the articles of association may specify that, in addition to the directors whose number and method of appointment are regulated in Articles L. 225-17 and L. 225-18, the board of directors shall include directors elected either by the company's employees or by the employees of the company and those of its direct or indirect subsidiaries which have their registered office located on French territory. The number of these directors may not exceed four, or five in companies whose shares are listed on a regulated market.

Directors appointed in these two situations shall not be taken into account for the determination of the minimum and maximum number of directors pursuant to Article L. 225-17 of the French Commercial Code (the board of directors shall be composed of at least three and not more than 18 members).

According to article L. 225-22 of the French Commercial Code, the number of directors bound to the company by an employment contract shall not exceed one-third of the board.

In addition to the requirements laid down in the Commercial Code, French companies whose securities are admitted to trading on a regulated market may comply wholly or in part with the provisions of a corporate governance code. As in other countries, the French corporate governance code is not compulsory. Nevertheless, if a company refuses to comply with the code or refuses to

[18] The exact figure is € 1,197,013,000,000, which was a 16% decline compared to 2010. For current data see https://europeanequities.nyx.com/fr/markets/nyse-euronext/paris. The listed companies included 528 domestic and 58 foreign corporations.

apply certain provisions, the chairman of the board of directors or of the supervisory board of a public limited company is required to give reasons for the non-compliance in a report.[19]

There are two main corporate governance codes, which can be designated by companies as their reference code:

- The AFEP[20]-MEDEF[21] Code is a set of recommendations based on the Viénot reports of July 1995 and July 1999, the Bouton report of September 2002, the January 2007 and October 2008 AFEP/MEDEF recommendations concerning the compensation of executive directors of listed companies, and the April 2010 AFEP/MEDEF recommendation concerning the strengthening of women's representation on boards. The aim of this Code is to define "*certain principles of good operation and transparency intended to improve management practices and to reinforce the confidence of investors and the public*"[22]; and
- The Middlenext Code, which is adapted to small and medium-sized firms.[23]

1.3 The board of a French company

French law allows companies to choose between a one-tier and a two-tier board structure:

- One-tier board structure:[24] This type of company is managed by a board of directors (*conseil d'administration*) composed of at least three directors (*administrateurs*) and not more than eighteen.
- Two-tier board structure:[25] These companies are administered by a management board (*directoire*) composed of not more than five members (or seven members for companies whose shares are traded on a regulated market). The management board exercises its duties under the control of a supervisory board (*conseil de surveillance*).

The two-tier system was introduced by the Law of 24 July 1966. The two-tier board structure was inspired by the German model. However, the one-tier structure is still by far the most common board model.

In addition, since 2001, corporations with boards of directors have the choice between the separation of the offices of chairman of the board and chief executive officer (*directeur général*) and maintenance of the aggregation of such duties in the hands of the *président directeur general* (PDG).[26] There are,

[19] Articles L.225-37 and L.225-68 of the French Commercial Code.
[20] AFEP (*Association Française des Entreprises Privées* – French Association of Private Companies) is an association of French private sector companies. The AFEP acts as a pro-business lobbying group. MEDEF (*Mouvement des Entreprises de France* – Movement of French Companies) is France's oldest and most important business confederation. The MEDEF succeeded in 1998 to the CNPF (*Conseil National du Patronat Français* – National Council of French Employers), which participated in the first Viénot Report.
[21] *Mouvement des Entreprises de France* (MEDEF).
[22] The consolidated version of the code is available at www.ecgi.org/codes/all_codes.php.
[23] See. P.-H. Conac, Code de Gouvernement d'entreprise pour les valeurs moyennes et petites, déc. 2009, Revue des sociétés 2010 p. 71.
[24] Article L.225-17 of the French Commercial Code.
[25] Articles L.225-57 and 58 of the French Commercial Code.
[26] See P.H. Conac, La dissociation des fonctions de président du conseil d'administration et de directeur général des sociétés anonymes selon la loi sur les Nouvelles Régulations Economiques (NRE)), Droit21 (www.droit21.com), November 2001, ER 052, Copyright Transactive 2000-2001, available at http://wwwen.uni.lu/fdef/law/equipe/pierre_henri_conac.

consequently, three forms of organisation of management and supervisory powers: The public limited company with a unitary board and separation of the offices of chairman and chief executive officer, the unitary board company with combined chairman and chief executive officer, and the public limited company with an executive board and a supervisory board.[27]

[27] For data regarding the diffusion of the three forms see Annex 1.

2 Concept of Company Director

2.1 De jure directors

2.1.1 Requirements to become a *de jure* director

The type of director differs from one company to another. SARLs, SNCs, SCSs are represented by managers (gérants). As explained above, the SA can be either directed by directors and a chief executive officer (the one-tier system) or by members of an executive board and supervisory board (the two-tier system). In the SAS, the powers of the board are exercised by the chairman or by those of the company's directors who are designated by the articles of association for this purpose.

The directors of the public limited company (*société anonyme*) are appointed by the shareholders' meeting.[28] The meeting cannot deliberate on an item that is not on the agenda.[29] Any appointment made in breach of the provisions is null and void.[30] Neither the company nor third parties may, in order to avoid their obligations, avail themselves of an irregularity in the appointment of persons charged with managing, administrating or directing the company if this appointment has been published in due form. The company may not rely, with respect to third parties, on appointments and withdrawals from the office of the directors if these have not been published in due form.[31] The term of the office of the directors shall be determined by the memorandum and articles of association but may not exceed six years.[32]

2.1.2 Who can be a de jure director?

The Commercial Code imposes an age limit in the following cases:

- SA with a unitary board structure: Unless otherwise provided for by the statutes, no more than one-third of the members of the board of directors may be older than seventy years.[33] Furthermore, the chairman of the board, the general manager and the assistant general manager shall not be older than sixty-five years.[34]
- SA with a dual board structure: No more than one-third of the members of the supervisory board shall be older than seventy.[35] The age limit for members of the management board is sixty-five, unless the statutes provide for a different age limit.[36]

A legal person may be appointed as a director or member of the supervisory board. Legal entities must appoint a physical person as permanent representative.

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[28] Article L. 225-18 of the French Commercial Code.
[29] Article L. 225-105 of the French Commercial Code.
[30] Article L. 225-18 of the French Commercial Code.
[31] Article L. 210-9 of the French Commercial Code.
[32] Article L. 225-18 of the French Commercial Code.
[33] Article L.225-19, al.2 of the French Commercial Code.
[34] Articles L.225-48, 54 of the French Commercial Code.
[35] Article L.225-70 of the French Commercial Code (the rule is comparable to Article L.225-19, i.e. the articles provide for a different age limit).
[36] Article L.225-60 of the French Commercial Code.

A legal person may not be appointed as chief executive officer of a one-tier SA, chairman of the board of a one-tier SA or member of the management board of a two-tier SA.[37] This rule was designed to allow the application of criminal liability to the senior management of a company, at the time where no liability for legal entities existed in France.

Non-EU nationals must have a residence before permit being appointed to office, which replaces the previous foreign merchant's permit.[38] Some professions are incompatible with the exercise of the functions of a director (lawyers, public notaries, civil servants, members of the government and members of the parliament, but only in state-controlled companies).

The CEO or a senior executive (*directeur général délégué*) can hold an employment contract in addition to his position. The two functions must be different. Otherwise, courts will consider that the work contract is suspended for the duration of the position of CEO or senior executive.

Multiple directorships in public limited companies are strictly regulated and limited. The limitations were significantly strengthened in 2001:

- The same individual can only hold one position as a member of the management board or as CEO of a company having its statutory seat in France.[39]
- The French Commercial Code provides that the same individual cannot hold more than five positions, whether as director or member of the supervisory board of a company having its statutory seat in France.[40] This prohibition does not apply to legal persons.
- The Commercial Code allows for exceptions to the prohibition of the same person holding more than five directorships in groups of companies.[41]

Article 8.1 of the AFEP-MEDEF Code provides that independent directors shall account for half of the members of the board in widely-held corporations without controlling shareholders. In controlled companies, independent directors shall account for at least a third of the board members. There is no definition of independence in the Commercial Code. According to article 8.1 of the AFEP-MEDEF Code, "*a director is independent when he or she has no relationship of any kind whatsoever with the corporation, its group or the management of either that is such as to colour his or her judgment. Accordingly, an independent director is to be understood not only as a non executive director, i.e. one not performing management duties in the corporation or its group, but also as one devoid of any particular bonds of interest (significant shareholder, employee, other) with them.*"

Since 2011, a balanced representation of men and women is required in the composition of the board of directors[42] or the supervisory board.[43] This principle is applicable to all public limited companies and specific sanction is attached to this requirement.

However, in companies with shares listed on a regulated market or in companies (SA and SCA but not the SAS) that are above certain thresholds during three consecutive fiscal years, there shall not be

[37] Article L. 225-59 of the French Commercial Code.
[38] Article L.311-1 and following of the French Foreigners Code.
[39] Article L.225-54-1, al.1 (one-tier system) and L.225-67, al.1 (two-tier system) of the French Commercial Code.
[40] Article L.225-21, al. 1, L.225-77, al.1 and L.225-94, al.1 of the French Commercial Code.
[41] Article L.225-21, al.2, L.225-77, al.1 and L.225-94, al.1 of the French Commercial Code.
[42] Article L.225-17 of the French Commercial Code.
[43] Article L. 225-69 of the French Commercial Code.

less than 40 % of directors of the same gender.[44] Listed companies will have to comply with this requirement in 2017 and others as soon as they have crossed the threshold.

Since 2008, directors are no longer obliged to own shares of the public limited company, unless otherwise provided for by the statutes.[45] According to the AFEP-MEDEF Code, any director of a listed company should be personally a shareholder and hold a fairly significant number of shares.[46]

2.2 De facto directors ("dirigeants de fait")

A *de facto* director has been defined by courts as someone who carries out management activities that bind the company, freely and independently, alone or together with other people, on a regular and continuous basis, without being a *de jure* director. Someone who interferes in the management of the company may be regarded as a *de facto* director,[47] for example, a person who presides over board meetings or takes individually major decisions for the company.[48]

De facto directors are treated as *de jure* directors as far as their duties are concerned, but they are not endowed with the powers of *de jure* directors.

[44] Article L.225-18-1 of the French Commercial Code.
[45] Article L. 225-25 of the French Commercial Code.
[46] Article 17 of the AFEP-MEDEF Code.
[47] M. Cozian, A. Viandier et F. Deboissy, *Droit des sociétés*, 22e éd., Litec, 2009, p. 131, n° 263.
[48] See for instance, Cass. Com. 12 July 2005, n°1238, RJDA 2/06 n°169.

3 SCOPE OF DIRECTORS' DUTIES UNDER FRENCH LAW

3.1 Types of directors' duties

3.1.1 Where regulated?

The scope and types of directors' duties have been progressively defined by the courts because of the lack of statutory definition. Indeed, statutory law only provides the grounds on which directors can be held liable, but does not determine the content of the duties applicable to company directors.

The Commercial Code establishes a specific liability regime for *de jure* directors of commercial companies.[49] Conversely, the liability regime applicable to *de facto* directors is governed by the general rules of tort law provided by article 1382 of the French Civil Code.[50]

3.1.2 Directors must act in the best interest of the company

Directors are required to exercise their powers in the company's best interest.[51] Statutes provide no definition of this concept. Accordingly, it has been defined on a case-by-case basis and its precise boundaries remain uncertain. The concept of the 'company's interests' can be interpreted in three ways: Judges may take account of the interests of the firm or business enterprise ("*intérêt de l'entreprise*"); the company's interests ("*intérêt social*"); or the shareholders' interests ("*intérêt commun des associés*"), depending on the facts. Thus, this notion, with variable content, is used as an instrument to take decisions adapted to the context and the specificity of the facts of each case.

The main interpretations of the company's interests that have been developed are as follows:

- The contractual approach ("*la conception contractuelle*"): According to this approach, the company's interests are equivalent to the shareholders' interests. The interests of all shareholders, and not only of the majority shareholder(s), should be taken into consideration. [52] This common interest ("*l'intérêt commun des associés*") is clearly stated in article 1833 of the French Civil Code. This article provides that "[e]*very company must have lawful objects and be formed in the common interest of the members.*" The common interest is essentially the interest in a share of the company's profits.

[49] Article L.223-22 and following for SARLs; art. L.225-251 and following for the one-tier SA; Art.L. 225-256 for the management board and L. 225-257 for the supervisory board.
[50] Cass. Com. 21.03.1995: Rev. svocietiés 1995, p. 501, B. Saintourens.
[51] Article 1848 of French Civil Code.
[52] See advocating this approach, D. Schmidt, De l'intérêt social, JCP éd. E, 21/9/1995 n°38, p 361; D. Schmidt, Les conflits d'intérêts dans la société anonyme : Version nouvelle, éd. Joly, 2004, 565 p.

- The institutional approach ("*la conception institutionnelle*"): The company is regarded as having its own interest, which includes, but is larger than, the shareholders' interest. In other words, this approach emphasises the interests of the company as a legal person. The reference to the *intérêt social* can be found in different provisions. This approach was firmly endorsed by the first Viénot report, which stated that the social interest can be defined as the "the over-riding claim of the company considered as a separate economic agent, pursuing its own objectives which are distinct from those of shareholders, employees, creditors including the internal revenue authorities, suppliers and customers. It nonetheless represents the common interest of all of these persons, which is for the company to remain in business and prosper."[53]

  This definition disappeared from the latest version of the Corporate Governance Code (2010), which now states that "[r]egardless of its membership or how it is organised, the Board of Directors is and must remain a collegial body representing all shareholders collectively. It is required to act at all times in the interests of the company" (Art. 1.1). The distinction and the reference between the representation of all shareholders and the interest of the company implies that the latter is not identical to the former and that a wide approach continues to prevail.[54]

- The interest of the firm ("*la conception inspirée de la doctrine de l'entreprise*"): At the beginning of the 1960's, the Rennes movement defined the company's interests as the interests of the firm or business enterprise. In this view, the company's interests comprise not only the interests of the shareholders, but also of the stakeholders (for example, creditors or employees). This interpretation was highlighted in the Fruehauf case of 1965.[1] In that case, an American parent company ordered its French subsidiary to refuse to deliver merchandise to a client from the People's Republic of China. This decision would have led to the downfall of the subsidiary and the loss of more than 600 jobs. The Court of Appeal decided to appoint an administrator to manage the company in order to protect the company's interests. It has been said that the judges took the employees' interests into consideration when making their decision. However, even though the interests of the employees are now protected by some legal provisions, it must be emphasised that this approach is not widely recognised in French corporate law.[1] Antoine Pirovano even states that the concept of the firm's interests ("*l'intérêt de l'entreprise*") has an imaginary dimension.[1]

The definition of the company's interest is important because it is the criterion to determine if the directors have committed acts of mismanagement (as developed below in 4.). Indeed, some authors consider this notion to be "*a compass that indicates the steps to be followed.*"[55]

The analysis of recent legal reforms reveals that the contours of the concept are still not clearly defined. It is impossible to determine which concept the French legislator favours. However, it can be noted that, in addition to the Corporate Governance Code, French case law adopts a wide interpretation of the social interest. [56]

[53] Rapport AFEP-CNPF, Le conseil d'administration des sociétés cotées, 1995, p. 8.
[54] P. Bézard, *Face-à-face entre la notion française d'intérêt social et le gouvernement d'entreprise*, Petites Affiches 2004, n° 31, p. 45, spéc. p. 47.
[55] M. Cozian, A. Viandier et F. Deboissy, *Droit des sociétés*, 22e éd., Litec, 2009, spéc. p. 184, n° 373.
[56] P. Bézard, *Face-à-face entre la notion française d'intérêt social et le gouvernement d'entreprise*, Petites Affiches 2004, n° 31, p. 45, spéc. p. 47.

3.1.3 Directors must act within their powers

Directors must comply with legal and regulatory provisions applicable to companies and with the company's by-laws.

3.1.4 Directors must avoid conflicts of interest

Three different categories of contracts should be distinguished in order to determine whether directors of a public limited company have the right to enter into such agreements:

– Prohibited agreements ("*conventions interdites*"):[57] There are a limited number of contracts that directors, unless they are legal entities (in order to take into account the reality of groups), do not have the right to conclude. For example, directors may not be granted a loan by the company as it is not the business of a company to make loans to directors and such possibility would easily give rise to abuses. Directors may not have their obligations towards third parties secured or guaranteed by the company. Loans granted or warranties made are null and void. This nullity is absolute, meaning that any aggrieved person can file a suit in court. The contracts cannot be ratified by the shareholders' meeting.

– Regulated agreements ("*conventions réglementées*"):[58] Agreements concluded by the directors with the company, or agreements in which a director has an indirect interest, need to be authorised in order to be valid. The authorisation process consists of five steps:[59]
  - The interested party must inform the board of directors (unitary board system) or supervisory board (dual board system) immediately upon becoming aware of a regulated agreement.
  - They must request prior authorisation by the board. The interested party may not participate in the vote.
  - The chairman of the board of directors shall advise the auditors of all agreements authorised.
  - The auditors shall present a special report on the agreements to the general meeting, which shall vote on this report.
  - Finally, the chairman shall submit the agreements to the general meeting for approval. The interested party may not participate in the vote and his/her shares shall not be taken into account for calculating the quorum and the majority.

  Agreements entered into without prior authorisation by the board of directors may be cancelled if they have prejudicial consequences for the company.[60] However, nullity may be avoided by a vote of the general meeting taken on the special report of the auditors setting out the circumstances by virtue of which the authorisation procedure was not followed. Nullity proceedings are time-barred after three years with effect from the date of the agreement. If the

[57] Article L.225-43, al. 1 and L.225-91 al. 1 of the French Commercial Code.
[58] Article L.225-38 and L.225-86 of the French Commercial Code.
[59] Article L.225-40 and L.225-88 of the French Commercial Code.
[60] Article L.225-42 and L.225-90 of the French Commercial Code.

agreement was concealed, the starting point for the period of limitation is the date on which the agreement was revealed.

- No authorisation is required for transactions that are entered into in the ordinary course of business and at arm's length ("*conventions libres*").[61] The notion of what is a current business transaction varies, with most courts holding that these are transactions frequently entered into by the company, and some courts adopting a more *in abstracto* approach and holding that the rules may also apply to contracts which, although infrequently concluded by the specific company, are often found in groups, such as contracts on cash pooling. These agreements are not subject to any formalities. Since 2009, they do not even need to be disclosed to the chairman of the board of directors or of the managing board.

The French securities regulator (*Autorité des marchés financiers* or AMF) recently set up an expert committee which released a report on "general meetings of shareholders of listed companies"[62] in February 2012, advocating some improvements with regard to regulated agreements in listed companies, which were, however, far too limited.[63]

3.1.5 Directors owe a duty of loyalty to the shareholders and to the company

The Commercial Code does not contain a codification of the duty of loyalty, but the existence of such a duty has been established by case law. In addition, the duty of loyalty was already implicitly recognised by the law, since the statute regulates, and sometimes prohibits, self-dealing. Directors owe a duty of loyalty to both shareholders and the company.

The legal basis for the duty of loyalty remains unclear.[64] It has been said that the duty of loyalty is based on the fact that a person assumes the role of director.[65] For some authors, the creation of the duty of loyalty is inspired by "fiduciary duties" of English law.[66] It has been argued that the duty of loyalty as developed by the French Supreme Court covers both the duty of care and the duty of fair dealing under English law.[67] Some authors conclude that the duty of loyalty is based on the principle of good faith.[68]

[61] Article L.225-39 and L.225-87 of the French Commercial Code.
[62] See Report of the working group on general meetings of shareholders of listed companies, Working Group chaired by Olivier Poupart-Lafarge, 7 February 2012. The report is available at www.amf-France.org.
[63] D. Schmidt, Conventions réglementées: commentaire du rapport du groupe de travail de l'AMF sur les assemblées générales d'actionnaires de sociétés cotées, Revue des sociétés 2012 p. 139.
[64] Hervé LeNabasque, Le développement du devoir de loyauté en droit des sociétés, RTD Com. 1999 p. 273.
[65] Henri Hovasse, Devoir de loyauté du dirigeant et cession de droits sociaux, Droit des sociétés n°7, Juillet 2008, comm. 156. Laurent Godon, Devoir de loyauté du dirigeant social envers les associés: et maintenant la question de la preuve de la déloyauté, Revue des sociétés 2007 p. 519, n°7.
[66] J.-J. Daigre, Le petit air anglais du devoir de loyauté des dirigeants, *Mélanges P. Bézard*, LPA/Montchrestien, 2002, p. 79. Laurent Godon, Devoir de loyauté du dirigeant social envers les associés: et maintenant la question de la preuve de la déloyauté, Revue des sociétés 2007 p. 519, n°7.
[67] Brigitte Daille-Duclos, Le devoir de loyauté du dirigeant, La semaine juridique entreprise et affaires n°39, 24 September 1998, p. 1486, n°10.
[68] Brigitte Daille-Duclos, Le devoir de loyauté du dirigeant, La semaine juridique entreprise et affaires n°39, 24 September 1998, p. 1486, n°24.

Duty of loyalty to shareholders

Directors are privy to key information about the company. They consequently have an obligation to ensure transparency. In fact, they have an obligation to enable shareholders benefit from the information, which mirrors the shareholders' right to be informed.

In its decision dated 27 February 1996,[69] the French Supreme Court (*Cour de cassation*) imposed a duty of loyalty on directors. In this case, the chairman of the board of a company not listed on the stock exchange was engaged in negotiations with a potential buyer who was prepared to purchase shares at a price of 8,000 French francs per share. At the same time, a minority shareholder requested the chairman to find a buyer for his shares. The director decided to purchase the shares of the minority shareholder himself for 3,000 French francs per share and resell them a few days later at a price of 8,000 French francs. The minority shareholder brought an action for compensation. The French Supreme Court approved the award of damages based on a breach of the duty of loyalty.

This holding was confirmed several times.[70] For instance, it was held by the French Supreme Court in a judgment delivered on 6 May 2008[71] that a director was in breach of the duty of loyalty by causing a company incorporated by him and his spouse to purchase shares of the company that he managed without revealing to the sellers that there were distributable profits superior to the price stipulated.

Duty of loyalty to the company

Directors must act in the best interests of the company. They consequently do not have the right to reveal information regarding the company to competitors. In a judgment dated 24 February 1998, the French Supreme Court made it clear that directors owe a wide duty of loyalty to the company. In that case, a director created a competing company after resigning. He encouraged other employees of the company that he had previously managed to resign as well. He offered them good opportunities in the newly created company. The Supreme Court found that the director was liable for a breach of the duty of loyalty owed to the company.[72] This decision was confirmed by another decision delivered by the French Supreme Court on 12 February 2002 where a former CEO of a limited company left the company and attracted former employees.[73]

Directors are subject to the duty of loyalty even if a non-compete clause is not stipulated in the director's employment contract. The duty comes into existence by virtue of the defendant acting in the capacity of a director. Furthermore, it could be said that the two variants of the duty of loyalty, the duty owed to the company and the duty owed directly to shareholders, are cumulative.

[69] Cass. Com. 27.02.1996, JCP E 1996, II, 838, D. Schmidt and N. Dion.
[70] Cass. Com. 12.05.2004: JCP E 2004, 1510, n°3, J.-J. Caussain, Cass. Com. 11.07.2006, n°05-12024: Dr. Sociétés 2007, n°1, H. Lécuyer.
[71] Com., 6.05.2008, n°07-13198: Dr. Sociétés 2008, n°156, H. Hovasse.
[72] CA Montpellier, 16 November 1999.
[73] Cass. Com. 12.02.2002: Rev. Sociétés 2002, p.702, L. Godon.

3.2 The director as a shareholder

A director is not bound by directors' duties when he acts as a shareholder during the general meeting. This solution can be explained by the fact that shareholders' voting rights cannot be used in a discretionary manner. A vote contrary to the company's interest ("*intérêt social*") is regarded as improper.

3.3 Begin and end of the duties

Directors can only be liable for faults committed during their term in office. They are not liable after termination of their directorship, with the exception of the duty of loyalty as mentioned above.

4 LIABILITY FOR BREACH OF DUTY

4.1 Directors' civil liability

Article L. 225-251 of the Commercial Code, applicable to the one-tier SA, provides that directors 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 content of this article is reproduced identically in article L. 225-256 for members of the management board, in article L. 223-22 of the Commercial Code, which governs the liability regime of directors of SARLs, and in article 1850 of the French Civil Code applicable to every commercial company unless otherwise provided for by statute.

The members of the supervisory board are subject to a different regime, since they do not manage the company but only supervise it. Article L. 225-257 of the Commercial code, applicable to the supervisory board provides that "[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."

Although the status of directors was originally influenced by agency law, as in other European countries, this has not been the case in France for a long time (although the term "*mandataires sociaux*", i.e. company agents, is still used in practice and in some provisions of the Commercial Code). The approach shifted from a contractual one to a legal one in the 1940s. According to a major decision of the French Supreme Court of 1946,[74] the distribution of power between the shareholders and the board of directors, and more generally between the organs of the public limited company, is considered relatively rigid. This decision, which was the consequence of legal chances in 1940 and 1943, marks the transition from a "contractual approach" to an "institutional approach" in French company law. Therefore, for instance, the shareholders cannot deprive the board of directors of all of its management powers. Another consequence is that the discharge (*quitus*) by the shareholders' meeting, a possibility originating from agency law, has no effect and cannot bar any civil or criminal action.[75] Even shareholders who voted for the discharged can later file a lawsuit.

The board of directors, acting as a body, is not subject to specific liability. The law places responsibility on individual directors. Nevertheless, the directors' responsibility is joint and several in case of common wrongdoing. Therefore, all the members of the board of directors or the management board are in principle liable for decisions made by these boards.

[74] Cass. Civ., 4 juin 1946: *JCP* 1947, II, 3518, note Bastian; J. Noirel, *in Les grands arrêts de la jurisprudence commerciale*, Sirey, 1962, p. 235.
[75] Article L. 225-253 al. 2 of the Commercial Code.

A major decision by the French Supreme Court from 2010 summarised the duties of the directors by holding that "it constitutes an individual mistake for each member of the board of directors of a public limited company who, by his action or abstention, participates in a wrongful decision of this body. The director is liable unless it is established that he behaved as a cautious and careful director, notably by opposing such decision" (*commet une faute individuelle chacun des membres du conseil d'administration ou du directoire d'une société anonyme qui, par son action ou son abstention, participe à la prise d'une décision fautive de cet organe, sauf à démontrer qu'il s'est comporté en administrateur prudent et diligent, notamment en s'opposant à cette décision*). [76] The law establishes a rebuttable presumption that any director, whether present or not, is liable for the wrongful decision of the board as a collective organ. In order to escape this liability, the director's opposition should be clear and recorded in the minutes. Thus, while the burden of proof is generally on the plaintiffs, once the court holds that a decision of the board was a management mistake, any director who wants to escape liability must prove that he opposed the decision.

This decision, taken also with other decisions, marks a more severe approach by the French Supreme Court towards directors' liability. However, in practice, a management mistake is mostly recognised in cases where the company has filed for bankruptcy. Cases where directors are found liable for management mistakes if the company is *in bonis* are rather rare.

The articles referred to above list three grounds on which directors can be found liable:

- Breach of the company's statutes: for instance, the breach of a statutory obligation to hold a certain number of shares or the violation of a clause that constrains the directors' powers (e.g., by prohibiting the company from entering into transactions above a certain amount without the authorisation of the shareholders[77]).
- Infringement of legal or regulatory provisions applicable to the company: for instance, the distribution of fictitious dividends, the refusal to disclose company documents to the shareholders, irregular fulfillment of a prescribed formality in convening and holding general meetings, or the failure to fulfill requirements relating to company accounts.
- Mismanagement: as stated previously, French legislation has not laid down any rules governing the care and diligence that a director should employ when discharging his/her functions. For this reason, French courts have defined the concept of mismanagement on a case-by-case basis.

The categories of possible misconduct vary. Directors may, for instance, be held liable for simple negligence, recklessness or fraudulent maneuvers. A positive action is not required. It is important to underline that intent to harm does not have to be proved. Moreover, a director could be liable even if the consequences are minimal.

Directors may be held liable for mismanagement of the company through any acts or omissions that are contrary to the company's interest (as developed before). The claimant must prove that a director's action is contrary to the company's interest and consequently affects the economic situation of the company. Fault shall be judged on the basis of what is considered to be a director's normal

[76] Cass. Com. 30.03.2010 n°08-17.841, FP-P+B+R+I, n° 08-17.841, *Fonds de garantie des dépôts (FGD) c/ Sté Caribéenne de conseil et d'audit*: P. Le Cannu: RJDA 7/10 n°760. Revue des sociétés 2010 p. 304.
[77] CA Paris 21.02.2003: Dr. societies 2004 comm. n°5.

conduct. Directors should be careful and diligent. Accordingly, fault is judged *in abstracto*. Nevertheless, this objective standard can be raised by taking into consideration the specific knowledge and experience of the director. For example, the reasonable care required from the director of a listed company is higher than the care that can reasonably be expected from the director of a family-owned and non-listed company.[78] On the other hand, courts do not make a difference whether the director is paid or not.

The French Supreme Court has given a list of examples of mismanagement. These could be categorised in the following way:

- Lack of monitoring: for instance, a director who delegated powers to another director and failed to supervise him was held liable.[79] In this case, the director did not take appropriate action against the agent when he was informed of misconduct of the agent;
- Failure to consult shareholders;[80]
- Poor results, but only if they can be explained by the directors' disinterest. For example, it can be argued that a director has committed mismanagement if he/she made no effort to improve the economic situation of the company and did not inform the company's shareholders of the gravity of the situation;[81]
- A trade policy contrary to the company's interest;
- The conclusion of a contract that could have detrimental effects for the company;[82] or
- Remuneration which is unreasonably high in relation to services rendered.[83]

Generally, the burden of proof is on the claimant since directors are only subject to a best effort obligation in the management of the company (*obligations de moyens*). The solution could be different in case of a breach of the company's statutes or an infringement of legal or regulatory provisions applicable to the company. In these situations, directors enter into a commitment guaranteeing a certain result (*obligation de résultat*).[84] Directors' mismanagement can be proved by any means.

4.2 Exemptions and limitations

In the case of a public limited company (société anonyme) no decision of the general meeting, either *ex ante* or *ex post*, and no provision in the articles of association, can shield directors and senior officers from liability (Art. L.225-253 C. Com.).

[78] JurisClasseur Sociétés: Fasc. 132-10: Administration: responsabilité civile des administrateurs, Yves Guyon, n°34.
[79] Cass. Com 6.02.1962: Bull. Civ. III n°80.
[80] Cass. Com. 12.03.1974: Gaz. Pal. 1974 p.662: Directors refused to call shareholders' meetings for years. This obstinacy to manage the company alone and without control leads to the dissolution of the company.
[81] Cass. Com. 5.06.1961: Bull. Civ. III n°254.
[82] Cass. Com. 8.06.1963: Bull. Civ. III n°283.
[83] CA Paris 17.01.1981, Sté des établissements Marlaud: in this case, remuneration was considered to be unreasonably high, because directors had only very limited tasks and the company was facing a substantial deterioration in its financial position.
[84] JurisClasseur Sociétés: Fasc. 132-10: Administration: responsabilité civile des administrateurs, Yves Guyon, n°31-32.

4.3 Insurance against liability

French law allows civil liability insurance for directors. The purpose of the insurance is to protect the directors against the financial consequences of civil liability actions. In practice, the company, and not the director or the shareholders, takes out the insurance. This point has been subject to debate and discussion since such payment could be considered to be an abuse of corporate assets (*abus de biens sociaux*), but the academic literature argues that the practice is legitimate.[85]

The recent development in directors' liability insurance was inspired by the United States, where D&O insurance is common. An increasing number of French companies nowadays take out insurance policies.

The beneficiaries of the insurance are both *de facto* and *de jure* directors. However, only natural persons who are directors are covered by the contracts, legal persons are excluded. Permanent representatives of legal persons who are designated as directors of a company may be covered by an insurance taken out by the company. Directors of subsidiaries and of lower-tier subsidiaries are generally included in the coverage taken out by the parent company.

The insurance applies to financial consequences of civil liability actions regardless of the grounds of liability (breach of the company's statutes, infringement of regulatory and legislative provisions, mismanagement etc.). Furthermore, directors are protected if they are personally ordered to bear all or some of the liability of a company that is being liquidated due to insufficient assets.

The contracts typically cover the following types of financial obligation:

- Damages to be paid by the directors;
- Costs of the civil or criminal defense (for example, legal fees, costs for expert opinions, fees and expenses of the bailiff, costs of the arbitration); and
- Costs of bail.

Some insurance contracts also cover the costs of psychological assistance provided to the defendant directors and their families.

However, limits are imposed by statute. Insurance coverage must not extend to:

- Criminal liability;
- Willful misconduct or intentional wrongdoing; and
- Personal injury.

[85] See A. Constantin, De quelques aspects de l'assurance de responsabilité civile des dirigeants sociaux, RJDA 7/2003. 595; and Jil El Ahdab, La prise en charge financière par la société de la responsabilité de ses dirigeants: vers un modèle américain ?, Revue des sociétés 2008 p. 239.

The fact that the directors may be liable to the company, the shareholders, or third parties is generally irrelevant. However, some contracts do not cover civil liability where the directors are liable to the company. Indeed, some insurance undertakings do not allow companies to take out insurance against liability that may in the end benefit them.

The analysis of French insurance practice shows that insurance undertakings generally require their clients to be incorporated for several years. In addition, they require a minimum balance-sheet total of approximately 10,000 Euro.[86]

It is advisable to respect the rules on regulated agreements so that minority shareholders cannot contest the validity of the insurance contract. Even if the contract is concluded between the company and the insurance undertaking, it is possible that courts may consider that it is concluded indirectly between the directors and the company.[87]

The total amount covered is provided in the insurance contract. This amount represents the global commitment of the insurance company for all claims occurring during the insurance period. On an indicative basis, this amount varies between 1-10 million Euro for SMEs. For larger firms, the maximum amount is generally around 150 million Euro.[88]

The insurance contracts rarely contain a deductible, with the exception of contracts covering the United States.[89] The insurance contribution varies according to the total amount covered and the turnover of the company during the last few years.

[86] Mémento Pratique Francis Lefebvre, Sociétés commerciales 2012, n°14560.
[87] A. Constantin, De quelques aspects de l'assurance de responsabilité civile des dirigeants sociaux: RJDA 7/03 p.595 n°32.
[88] Mémento Pratique Francis Lefebvre, Sociétés commerciales 2012, n°14660.
[89] Mémento Pratique Francis Lefebvre, Sociétés commerciales 2012, n°14690.

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 The meaning of ‘vicinity of insolvency’

The commencement of insolvency proceedings must be requested by the legal representative of the company at the latest within forty-five days following the cessation of payments if the legal representative has not, within this time limit, requested the commencement of conciliation proceedings.[90] Cessation of payments means that the company is unable to meet its current liability with its available assets. The situation of the company is assessed on the day the court rules on the case.

5.2 Consequences

5.2.1 Action to make good liability (“action en responsabilité pour insufissance d’actif”)[91]

Pursuant to article L.651-2 of the French Commercial Code,[92] any *de jure* or *de facto* manager may be ordered personally to bear all or some of the liability of a company that is being liquidated due to insufficient assets, whenever he/she has committed acts of mismanagement that have contributed to the lack of assets.

This remedy is only available during the liquidation procedure (“*liquidation judiciaire*”), but not the safeguarding procedure (“*procedure de sauvegarde*”) or the reorganisation under the supervision of the court (“*redressement judiciaire*”). Two conditions need to be satisfied: The director must have made an error during his/her management and a causal link must exist between the error and the insufficiency of assets. The fact that a director does not file for insolvency within the legal time period is regarded as mismanagement that has contributed to the lack of assets.[93]

This specific liability regime excludes the application of rules on directors’ liability in the Commercial Code (article L. 225-251) and in the Civil Code (article 1382 and 1383).[94] However, an action on the basis of article L. 225-251 of the Commercial Code is possible if the basis for such action is different than the lack of assets.[95] In any case, shareholders are able to instigate legal proceedings against a director on the basis of a personal claim for damages.[96]

[90] Articles L.631-4 of the French Commercial Code for the reorganization procedure and L.640-4 for the liquidation procedure.
[91] Before 2008: *action en comblement de passif*.
[92] French Act No. 2008-1345 of 18 December 2008.
[93] Cass. Com. 30.11.1993: RJDA 4/94 n°460.
[94] Cass. Com. 20.06.1995 n°1309, RJDA 7/95 n°904, Cass. Com 26.05.1999 n°1024: RJDA 3/00 n°324.
[95] Cass. Com. 09.03.2010, FS-P+B, n° 08-21.547, *Sté EPF Partners c/ Abela*, Revue des sociétés 2010, p. 230, H. Le Nabasque.
[96] See below section 6.1.1.1.

The action can be brought at the same time as an action to enforce a tax liability based on article L.2 67 of the French Tax Procedure Code (*Livre des procédures fiscales*)[97] or a civil liability action for a loss resulting from an offence.[98]

The action to make good a deficiency in the company's assets can be brought both against *de facto* and *de jure* directors. Members of the supervisory board are not considered as *de jure* directors. The legal representative of a legal person being a director can also be sued individually in this action.

The burden of proof to show that the defendant is a *de facto* director lies with the claimant. The claimant is the body that initiates the insolvency proceedings. A *de facto* director has been defined by the courts as someone who carries out management activities freely and independently, alone or together with other people, on a regular and continuous basis.[99]

5.2.2 Other sanctions

The director of an insolvent company may also be subject to administrative sanctions such as disqualification or criminal sanctions for bankruptcy for acts performed in the vicinity of insolvency. These sanctions are discussed below in section 6.2.

[97] Cass. Com. 9.12.1997: RJDA 1/98 n°87 concl. Pinot.
[98] Cass. Crim 10.10.2001 n°6239: RJDA 4/02 n°417.
[99] See above section 2.2.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue?

6.1.1 The company as plaintiff

The person who has the right to enforce directors' duties and instigate legal proceedings against the directors is logically the company, acting through its directors (*action ut universi*), not the shareholders in general meeting. Nevertheless, it is evident that the directors may be reluctant to bring an action against themselves. For this reason, French legislation, as early as 1867,[100] authorised the shareholders to take action on behalf of the company against the directors (*action sociale ut singuli*).[101] The *action sociale ut singuli* will be analysed below.

6.1.2 The shareholders as plaintiffs

6.1.2.1 In their own name

If the aim of the action is not to recover for the damage sustained by the company, but to claim compensation for the individual harm suffered by one or more shareholders (individual damage), the shareholders may bring an action in their own name against the directors (*action individuelle*). This possibility was established in the 20th century.[102]

However, the individual harm suffered by the shareholder must not be the consequence of a loss sustained by the company, since in such case the damage would be only indirect.

The classical example for individual harm is the misappropriation by a director of dividends owed to the shareholders.

In another case, the directors were found liable where they had deliberately misled the minority shareholders about the reasons and conditions of a capital reduction in order to buy their shares at a lower price.[103] The French Supreme Court in this case did not specify the legal grounds on which the directors were liable. It could be argued that this was an example for a breach of the duty of loyalty. The overvaluation of a contribution in kind, which causes the dilution of existing shareholdings, is also regarded as a potential individual harm.[104]

The decline in the value of shares resulting from mismanagement is not considered to be an individual harm. Rather, the loss suffered by the shareholders is simply the consequence of the damage

[100] V. C. Houpin et H. Bosvieux, Traité général des sociétés civiles et commerciales, Tome II, 6e éd., 1929, p. 553. The French 1867 Companies Act also included a provision which implicitly allowed for an *action sociale ut singuli* (Art. 17).
[101] Article 1843-5 of the French Civil Code.
[102] Civ. 26 nov. 1912, D.P. 1913. 1. 377, note E. Thaller.
[103] Cass. Com. 8.11.2005: Bull. Joly 2006, §99, p.502.
[104] Cass. Com. 28.06.2005: RJDA 10/05, n°1107.

sustained by the company.[105] Similarly, the diminution of the company's assets cannot be regarded as an individual harm suffered by the shareholders.[106] In this situation, the action open to the shareholders is the *action sociale ut singuli* for compensation for the loss suffered by the company.

An important development occurred in this area recently. Since 2005,[107] the French Supreme Court has accepted to indemnify shareholders who bought or sold shares on the basis of misinformation which led to a decrease in the value of the stock. Courts consider that shareholders suffered a "loss of opportunity" to invest or disinvest.[108] This development has led to substantial indemnifications and, therefore, to an increased interest from aggrieved shareholders.

If several shareholders of the public limited company suffer a direct and individual harm resulting from the same facts, such as misinformation, they may bring an action together. One of them may act on behalf of the others, provided that the following conditions are met:[109]

- The mandate to represent the other shareholders shall be in writing and expressly mention that the authorised person has the power to perform the necessary acts during the proceedings on behalf of the constituent, and as the case may be, to exercise appeals and
- The claim shall mention the first names, last names, and addresses of every constituent, the number of shares held and the compensation claimed by each of them.

There is no class action in France. However, in many suits for damages, shareholders have joined together and created groups of as many as seven hundred persons with the same lawyer (e.g., currently Natixis) in order to share the costs. Courts have treated plaintiffs generally as one class by giving them the same amount of damages without distinguishing according to their personal situations. This new attitude of French courts has led to what is, in practice, an equivalent system to class actions. However, there are fewer shareholders involved than in the United States since it is an *opt-in* system and shareholders have to pay up-front fees for their lawyers.

The debate about whether to introduce a class action in France was reopened in 2010 by a report in the French upper house.[110] At the same time, the French securities regulator is considering, on the model of the Fair Funds introduced by Sarbanes-Oxley,[111] to take into account the indemnification of shareholders when assessing administrative penalties.[112] The idea had already been advocated.[113]

[105] Cass. Com. 1.04.1997: Bull. Joly 1998, p.650.
[106] Cass. Com. 21.09.2004 n°1241: RJDA 12/04 n°1326.
[107] Com. 22 nov. 2005, n° 03-20.600, *société Eurodirect marketing c/ M. Michel Pfeiffer*, F-D, RTD com. 2006. 445, obs. M. Storck; cité par J.-J. Daigre, Rev. sociétés 2007. 102.
[108] See for a recent exemple, Cass. Com. 09.032010, FS-P+B, n° 08-21.547, *Sté EPF Partners c/ Abela*, Revue des sociétés 2010, p. 230, H. Le Nabasque.
[109] Article R.225-167 of the French Commercial Code.
[110] Rapport d'information au nom de la commission des lois constitutionnelles, de législation, du suffrage universel, du Règlement et d'administration générale (1) par le groupe de travail sur l'action de groupe, par MM. L. Béteille et R. Yung, Sénat, n°499, enregistré à la présidence du Sénat le 26 mai 2010.
[111] Section 308(a).
[112] P.-H. Conac, Groupe de travail présidé par Jacques Delmas-Marsalet et Martine Ract-Madoux, membres du Collège de l'AMF, 25 janvier 2011, Revue des sociétés 2011 p. 252.
[113] M.-C. Robert Hawes, Some modest proposals to provide viable damages remedies for French investors, *in* M. Tison et *al.* (eds.), *Perspectives in Company Law and Financial Regulation: Essays in Honour of Eddy Wymeersch*, Cambridge University Press, 2009, p. 223.

6.1.2.2 In the name of the company ('derivative action')

In order to address the conflict of interest identified above when directors are faced with the decision whether to enforce the company's rights against a director (*action sociale ut universi*), the shareholders have the possibility to bring the action themselves, but in the name of the company (*action sociale ut singuli*). According to the general rules of the Civil Code, every shareholder has this right to bring this action, even if he/she only holds one share. Shareholders must hold at least one share during the whole duration of the proceedings.[114]

The Commercial Code provides for additional rules in order to facilitate the *action sociale ut singuli* brought by the shareholders of a public limited company (SA). Shareholders holding shares representing more than 5% of the share capital can act together. Lower thresholds are provided for companies with a legal capital exceeding 750,000 Euros.[115] This action is of a subsidiary nature. It can only be initiated if the representatives of the company refuse to take legal action.

In order to ensure the effectiveness of the proceedings, the Commercial Code contains the following provisions that apply whenever a claim of the company is enforced against the directors:[116]

- A provision in the memorandum or articles of association that makes the exercise of the action subject to prior notice or the authorization of the general meeting is invalid.
- A provision in the memorandum or articles of association that has the effect to waive the right to any such action in advance is invalid.
- Finally, the discharge given by the shareholders' meeting shall not be an obstacle to a subsequent civil liability action.

The derivative action permits damages to be awarded to the company but not the shareholders.[117] In practice, this has the consequence that the derivative action is not commonly used because the shareholders bear the costs of the proceedings without receiving any direct benefit from the action.

The statute of limitation is three years from the date of the act or event causing the loss or damage or, where the act was concealed, from the date of discovery thereof.[118] If the act constitutes a crime, the period of limitation is ten years. Finally, it should be noted that the *action sociale ut singuli* cannot be brought against members of the supervisory board.[119]

6.1.3 Action brought by third parties

Under specific, restrictively interpreted conditions, the directors may be liable directly in relation to third parties. Shareholders are not considered to be third parties.[120]

[114] Cass. Com. 26.01.1970: Bull. Civ. IV n°30.
[115] Article R.225-169 of the French Commercial Code.
[116] Article L.225-253 of the French Commercial Code.
[117] Article 1843-5 of the French Civil Code and for SAs: Article L.225-252 of French Commercial Code.
[118] Article L.225-254 of the French Commercial Code.
[119] Article L.225-257 regarding the liability of members of the supervisory board does not provide for this kind of action.
[120] Cass. Com. 09.032010, FS-P+B, n° 08-21.547, *Sté EPF Partners c/ Abela*, Revue des sociétés 2010, p. 230, H. Le Nabasque.

For such liability to arise, courts require that the directors have committed a fault that is separable from their functions (*faute séparable des fonctions*). This doctrine stems from administrative law and was transposed into corporate law by the courts. Civil servants are liable not just for an administrative fault, but for a personal fault that does not fall within the exercise of their duties. Similarly, in company law, a third party may bring an action directly against the director if the director commits a separable wrong.[121] However, this doctrine is also a direct consequence of the existence of a corporate veil and of the fact that the director is an agent of the company.

Initially, courts found directors only liable in exceptional cases on the grounds that a wrong was separable from the director's functions. For example, a misuse of powers was not enough to give rise to an action by third parties.[122] Willful misrepresentation by the director in performing a contract was not judged to be a separable fault.[123]

However, since a judgment by the French Supreme Court from 20 May 2003 the courts have adopted a less lenient approach. In this case, the French Supreme Court held that directors can be found liable to third parties where they deliberately commit a particularly serious fault that is incompatible with the normal exercise of their functions. Accordingly, two conditions must be satisfied:

- The defendant director must have acted intentionally and
- The director's act must have been particularly serious.

In the case decided by the Supreme Court, the manager had assigned two receivables to a supplier in order to pay for a delivery, although he had previously assigned these two receivables to a bank. The Court held that the director had misled the supplier as to the company's solvency and was liable to this supplier.[124]

In another judgment, a director was held liable to the company's employee where he had not informed the employee that the employee's executive car was not insured.[125] The director of a company running a discotheque was liable because he refused to comply with copyright law without any reason.[126]

A recent decision by the French Supreme Court of 10 February 2009[127] confirms that the interpretation of "separable fault" adopted by the courts has become more stringent. The Supreme Court held that directors could be found liable to third parties even if they did not exceed the limits of their powers.

[121] JurisClasseur Commercial: Fasc. 1053: Dirigeants sociaux: responsabilité civile, Denis Gibirila, n°28; JurisClasseur Sociétés: Fasc. 132-10: Administration: responsabilité civile des administrateurs, Yves Guyon, n°59.
[122] Cass. Com. 20.10.1998: JCP 1998, p.2025: a director granted a guarantee on behalf of the company without obtaining the authorization of the board of directors.
[123] Cass. Com. 28.04.1998: Bull. Joly 1998, p.888: The directors said that boilers were the company's property. However, the boilers were encumbered with a reservation of title clause.
[124] Cass. Com. 20.05.2003 n°851: RJDA 8-9/03 n°842, p.717 / Cass. 1ere Civ., 16.11.2004: Bull. Joly 2005, p.305 The First Chamber of the French Supreme Court adopted the same definition of separable fault from the director's functions as the Commercial Chamber.
[125] Cass. Com. 4.07.2006 n°865: RJDA 2/07 n°166.
[126] Cass. 1ere Civ.16.11.2004 n°1653: RJDA 3/05 n°277.
[127] Cass. Com. 10.02.2009 n°07-20.445: RJDA 5/09 n°445.

Nevertheless, it should be recognised that, depending on the facts of the case, it may be difficult to predict whether the courts will regard a director's act as a separable fault. The concept of separable fault is defined on a case-by-case basis and has, arguably, increased legal uncertainty. In practice, Courts admit very seldom a fault that is separable from the director's functions.

6.2 Administrative and criminal sanctions

6.2.1 Disqualification[128]

The court may pronounce the personal disqualification of any *de jure* or *de facto* director or any natural person who serves as permanent representative of a legal entity appointed director of a company. Disqualification requires that any of the following facts has been proved:

- Abusively operating an unprofitable business that would necessarily lead to the cessation of payments for personal gain;
- Embezzling or concealing all or part of the company's assets or fraudulently increasing its liability;
- Running a commercial, craftsman or agricultural activity or holding a management or administrative position in a legal entity in violation of a prohibition provided for by law;
- Purchasing goods or services for resale at below market prices or using ruinous means to procure funds with the intention of avoiding or delaying the commencement of reorganisation or liquidation proceedings;
- Entering into commitments deemed to be disproportionate when they were entered into, given the situation of the business or the legal entity;
- Paying or causing someone else to pay a creditor, after cessation of payments and while being aware of this, to the prejudice of other creditors;
- Hampering the good progress of the insolvency proceedings by intentionally abstaining from co-operating with the authorities in charge of the proceedings;
- Destroying accounting documents, not keeping accounts where applicable laws made this an obligation or keeping accounts that are fictitious, manifestly incomplete or irregular with respect to the applicable provisions.

Personal disqualification shall entail a prohibition from running, managing, administering or controlling, directly or indirectly, any commercial or craftsman's business, any agricultural activity or any business operating any other independent activity and any legal entity.

Moreover, directors who are disqualified are deprived of voting rights. The court may order these managers or some of them to sell shares or share capital of legal entities or order a forced sale through a court nominee, if necessary after obtaining an expert's report. The court may also pronounce the ineligibility to occupy a public office. The ineligibility shall last for the duration of the personal disqualification, without exceeding a five-year period. Disqualification is time-barred after three years from the issuance of the order pronouncing the commencement of the insolvency proceedings.

[128] Articles L 653-1 to 653-11 of the French Commercial Code.

6.2.2 Prohibition from running, managing, administering or controlling any commercial or craftsman's business or any agricultural activity[129]

In the cases discussed in the preceding section (personal disqualification), a court may pronounce, instead of disqualifying the director, a prohibition from managing, running, administering or controlling, directly or indirectly, any commercial or craftsman's business, any agricultural activity or any legal entity or one or more of these.

The same prohibition may also be imposed against directors who have failed to file, within the time limit of forty-five days, a statement of cessation of payments, without having otherwise filed for the commencement of conciliation proceedings.

As in the case of disqualification, directors are deprived of voting rights and may be forced to sell their shares.

6.2.3 Criminal offences applicable to directors (except bankruptcy)

- Distributing sham dividends between the shareholders in the absence of an inventory or using fraudulent inventories[130] and
- Failing to prepare the financial statements, or publishing accounts that the directors know to be inaccurate or that do not present a true and fair view of the company's financial position.[131]

The most important criminal provision is the abuse of corporate assets (*abus de biens sociaux*). It punishes, among others, board chairmen, directors or managing directors of a public limited company (as well as members of the managing board) or a limited liability company (SARL) who "use the company's property or credit, in bad faith, in a way which they know is contrary to the interests of the company, for personal purposes or to favor another company or undertaking in which they have a direct or indirect interest." The penalty is a prison term of up to five years (with no minimum) and a fine of up to 375,000 Euros.[132] This criminal offense, which dates back to 1935, is widely used by minority shareholders in cases of management overreaching.

The company's interest is consequently used as the criterion to determine if directors' acts amount to a misuse of company assets. In this context, the Criminal Chamber of the French Supreme Court defines the company's interest as the interest of the company and not just the shareholders ("*intérêt de l'entreprise*"). The Court states that '*the offence of the misappropriation of company assets has been created not to protect the shareholders' interests but to protect the assets of the company, the company's interest, and the interest of third parties'*.[133]

[129] Article L.653-8 of the French Commercial Code.
[130] Article L.242-6, 1° of the French Commercial Code.
[131] Article L.242-6, 2° of the French Commercial Code.
[132] Article L.242-6, 3°, 4° of the French Commercial Code.
[133] Cass. crim. 5 novembre 1963, Bull. crim. n° 307; D. 1964, p. 52: In this case, the defendants argued that they could not be charged with the offence of misuse of company assets because all the shareholders had agreed to the transaction.

In France, the minority shareholders, acting derivatively in the name of the company (*action sociale ut singuli)*, can initiate a criminal prosecution by filing a criminal complaint (*plainte avec constitution de partie civile*) with the Dean of the Examining magistrates (*Doyen des Juges d'Instruction*) of the Civil first degree court (*Tribunal correctionnel*). In order for the complaint to be admissible, it is enough that the circumstances which gave rise to the complaint allow the examining magistrate to consider "possible" the existence of the damage to the company and the link with the alleged abuse of corporate assets. Case law has long made it clear that the examining magistrate has a duty to investigate, as long as she deems this undemanding standard to be met. This remedy is very attractive for minority shareholders since the examining judge holds the ability to access documents, and at no or very little cost for the plaintiff shareholder. As a consequence, criminal prosecutions for *abus de biens sociaux* are relatively frequent in France.[134]Also, the offence can give rise to indemnification. Therefore, this criminal liability can be used by minority shareholders as an alternative way to engage the civil liability of directors and managers. In addition, the French Supreme Court applies the statute of limitation in a very favorable way to the plaintiff when the offence was concealed from the company. Case law tends to be restrictive as to when the offence was disclosed, which triggers the three years starting point of the statute of limitation.[135]

For the analysis of whether the directors have acted in breach of the company's interests it is mportant to consider whether the company belongs to a group. It may be possible to justify acting temporarily against the company's interests in light of the fact that the group's common interest ("*intérêt commun du groupe*") and the development of the group have been furthered.[136] The group's interest has been used as a justification for a misuse of company assets since the judgment of the French Supreme Court of 4 February 1985 ("*Arrêt Rozenblum*"). According to this decision, financial assistance to a company of the same group will not be qualified as a misuse of company assets if:

- The financial assistance was dictated by a common economic or financial interest;
- There is compensation;
- The balance of the respective commitments of the different companies of the group is not disturbed; and
- The financial means of the company are not exceeded.

The rules laid down by articles 121-3 of the French Criminal code apply. Therefore, a director does not commit any felony or misdemeanor in the absence of intent. The offences are punishable by a prison sentence of five years and a fine of 375,000 Euros,[137] with the exception of the failure to prepare the financial statements, which shall be punished by a fine of 9,000 Euros.[138]

Article L.249-1 of the French Commercial Code provides that a court may pronounce, in addition to the other sanctions, a prohibition from managing, running, administering, or controlling, directly or indirectly, any commercial business.

The statute of limitations for criminal actions is three years from the date of the act or omission resulting in the loss, or, if the act was concealed, from the date it is discovered.

[134] P.-H. Conac, L. Enriques, and M. Gelter, "Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy", European Company and Financial Law Review (ECFR), December 2007, Vol. 4, n°4,
[135] Cass. crim. 13.12.1989, Bull. crim. N°69.
[136] Marie-Emma Boursier, Le fait justificatif de groupe de sociétés dans l'abus de biens sociaux: entre efficacité et clandestinité, Revue des sociétés 2005 p. 273.
[137] Article L.242-6 of the French Commercial Code.
[138] Article L.242-8 of the French Commercial Code.

Directors may be exempted from criminal liability if they prove that they delegated their duties to a competent person who was provided with sufficient authority and the necessary means.[139] Proof of the delegation of powers may be established by any means. The delegation must be temporary and clearly defined to be valid. In order to be exonerated, directors should not have personally and directly participated in the infringement.

6.2.4 Criminal bankruptcy[140]

Directors are guilty of criminal bankruptcy where they commit any of the following offences:

- Purchasing for resale at below market prices or using ruinous means to obtain funds with the intention of avoiding or delaying the commencement of the reorganization proceedings;
- Embezzling or concealing all or part of the debtor's assets;
- fraudulently increasing the debtor's liability;
- Keeping fictitious accounts or destroying accounting documents belonging to the business or legal entity or failing to keep any accounts where the applicable texts impose an obligation to do so; and
- Keeping accounts that are manifestly incomplete or irregular with regard to legal provisions.

Criminal bankruptcy is punishable by five years imprisonment or a fine of 75,000 Euros. Directors may also be prohibited from exercising civic, civil and family rights, or from occupying a public office, for a maximum period of five years, or from issuing cheques other than those allowing for the withdrawal of funds by the drawer from the issuing bank or from issuing certified cheques. Directors may also be ineligible for public procurement contracts for a maximum period of five years.

6.2.5 Tax liability

Article L.267 of the French Tax Procedure Code provides that directors may be ordered personally to pay taxes owed by the company if they irregularly postponed the payment of taxes.

[139] Cass. Crim. 11.03.1993: RJDA 5/93 n°470, Cass. Crim. 19.09.2007: RJDA 2/08 n°167.
[140] Articles L.654-1 to L.654-7 of the French Commercial Code.

7 CONFLICT OF LAWS

There are two main theories to determine which law is applicable to a company:

- Incorporation theory: the company is governed by the law of the country where it was incorporated; or
- Real seat theory: the company is governed by the law where the centre of management and control is located.

French law follows the incorporation theory. Article L. 210-3 of the Commercial Code states that "[c]ompanies whose registered office is located on French territory shall be subject to French law. Third parties may avail themselves of the registered office, but it shall not be opposed with respect to them by the company if its real office is located in another place."

This means that the provisions of the French Commercial Code only apply to companies incorporated in France, whilst foreign companies are regarded as being governed by the laws of their place of incorporation, irrespective of where the company's centre of management and control is located. The rule applies bilaterally and internationally. A company whose statutory seat is located in a foreign country will be considered a foreign company.

The second paragraph in article L. 210-3 Commercial Code holds that third parties (contractors etc.) can sue the company where its real seat is located, if it is in a different place than the statutory seat. However, the company cannot force them to file the suit in the jurisdiction where the real seat is located. This means that a company whose seat is located outside France could be sued in France if its real seat is in France. Specific rules could apply. From a historical perspective, the goal of this rule was to prevent cases of fraud where an essentially French company would apply for foreign status in order to escape French law, while having its real seat in France.

Directors' duties and liability are governed by the *lex societatis*.[141] The *lex societatis* determines the directors' civil liability: mismanagement; breach of the company's statutes; infringement of legal or regulatory provisions applicable to the company; conflict of interest; and breach of the duty of loyalty.[142] The *lex societatis* also applies to questions of enforcement of duties by way of *action ut singuli*, *action ut universi*, or action for the individual harm suffered by the shareholder.[143]

The relationship between the company and its directors cannot be qualified as an ordinary contractual relationship. Accordingly, the *lex contractus*[144] is irrelevant for our purposes.

The *lex loci delicti* is applicable if a director commits a tortuous act.[145]

[141] Daniel Cohen, La responsabilité civile des dirigeants sociaux en droit international privé, Revue critique de droit international privé 2003 p. 585, n°16; Hervé Synvet, Droit international privé, Société, Répertoire international Dalloz, n°111.
[142] Daniel Cohen, La responsabilité civile des dirigeants sociaux en droit international privé, Revue critique de droit international privé 2003 p. 585, n°25.
[143] Daniel Cohen, La responsabilité civile des dirigeants sociaux en droit international privé, Revue critique de droit international privé 2003 p. 585, n°26.
[144] Yvon Loussouarn, Fasc: 570-40: Conflits de lois en droit des sociétés.
[145] Hervé Synvet, Droit international privé, Société, Répertoire international Dalloz, n°112.

Finally, as far as directors' criminal liability is concerned, French law applies to offences committed in France.

ANNEX 1 :

Second annual report on the AFEP-MEDEF Code: Application of the Corporate Governance Code by the companies of the SBF 120 index

November 2010

Distribution of the companies according to corporate form and the form of organization of the management and supervisory powers

	SBF 120[146]		CAC 40	
	2008	2009	2008	2009
One-tier public limited company with separation of the offices of chairman and chief executive officer	49.5 %	46.6 %	34 %	40 %
One-tier public limited company with combined offices of chairman and chief executive officer	25.7 %	30.1 %	43 %	37 %
Public limited company with a management board and a supervisory board (Two-tier board structure)	21 %	19.4 %	17 %	17 %
Limited partnership with shares	3.8 %	3.9 %	6 %	6 %
TOTAL	100 %	100 %	100 %	100 %

[146] The SBF 120 (*Société des Bourses Françaises 120 Index*) is a French stock market index. The index includes the main 120 traded stocks listed in Paris. It includes all 40 companies of the CAC 40 index plus a selection of 80 additional companies with the largest French stock market capitalisation.

DIRECTORS' DUTIES AND LIABILITY IN GERMANY

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CONTENTS

LSE Enterprise

1 INTRODUCTION

German company law is statutory law belonging in general to the field of private law. Nevertheless, case law plays an important role in developing, amplifying, and interpreting the statutory rules. In addition, jurisprudential literature is widely discussed and taken into consideration by courts and has, accordingly, a major impact on judge-made law and legal interpretation.

The following table shows the different types of companies that can be established in Germany, the regulatory framework that effects the operation of the respective type of company, the form of ownership and board structure.

Table 1: Overview of the corporate landscape

Type of company	Regulatory framework	Ownership structure	Board structure
Civil law partnership (*Gesellschaft bürgerlichen Rechts*)	§§ 705 seq. BGB[1]	private ownership	–
Commercial partnerships (*Personenhandelsgesellschaften*: general partnership, *offene Handelsgesellschaft*, *oHG*; limited partnership, *Kommanditgesellschaft*, *KG*)	§§ 105 seq. HGB[2]	private ownership	–
Partnership company (*Partnerschaftsgesellschaften*)	PartGG[3]	private ownership	–
Associations (*Vereine*)	§§ 21 seq. BGB	private ownership	one tier[4]
Public limited company (*Aktiengesellschaft*, *AG*)	AktG[5]	institutional ownership	two tier[6]
Limited liability company (*Gesellschaft mit beschränkter Haftung*, *GmbH*)	GmbHG[7]	private ownership	**one tier**[8]/optional two tier[9]/mandatory two tier[10]
Cooperatives (*Genossenschaften*, eG)	GenG[11]	private ownerships	two tier[12]

[1] Bürgerliches Gesetzbuch (Civil Code).
[2] Handelsgesetzbuch (Commercial Code).
[3] Partnerschaftsgesellschaftsgesetz (Partnership Company Act).

2 THE CONCEPT OF 'COMPANY DIRECTOR' IN GERMANY

2.1 De jure directors

2.1.1 Requirements to become a *de jure* director

The ability to become a *de jure* director of a public limited company is governed by section 84 of the Stock Corporation Act (AktG). In German company law two different legal relationships exist between directors and public limited companies: one regards the corporate, the other the contractual aspects of the appointment as director (section 84(1), sentences 1 and 5, 84(3), sentences 1 and 5 AktG).[13] The law distinguishes between the appointment of the director and the engagement as an employee (theory of disjunction, *Trennungstheorie).* The supervisory board appoints the director (section 84(1) sentence 1 AktG).[14] It decides by means of a resolution[15] and communicates the decision to the future director, who has to give his consent. The director does not have to be assigned a specific area of business in the appointment process.[16]

There are four different ways to become a *de jure* director in a limited liability company:

- the articles of association may provide for the appointment of the directors (section 6(3), sentence 2, 6(4) GmbHG);
- in case the articles of association do not provide for the appointment of the directors and the company does not have a supervisory board, the directors are appointed by the members (sections 6(3), sentence 2, 46 no. 5 GmbHG);
- if a supervisory board is mandatory, e.g. according to sections 31 MitbestG; 12 Montan-MitbestG; 13 MitbestErgG, the supervisory board appoints the director;

[4] § 26 BGB.
[5] Aktiengesetz (Stock Corporation Act).
[6] §§ 86–99; 111 AktG.
[7] Gesetz betreffend die Gesellschaften mit beschränkter Haftung (Limited Liability Company Act).
[8] § 6 GmbHG.
[9] § 52 para I GmbHG: if agreed upon in the articles of association.
[10] § 1 para I No. 3 DrittelBG: 'Die Arbeitnehmer haben ein Mitbestimmungsrecht im Aufsichtsrat nach Maßgabe dieses Gesetzes in […] einer Gesellschaft mit beschränkter Haftung mit in der Regel mehr als 500 Arbeitnehmern' – *The employees have a right of codetermination in the supervisory board in accordance with the conditions of this law in a limited company with usually more than 500 employees*; § 31 MitbestG, § 12 Montan-MitbestG, § 13 MitbestErgG.
[11] Genossenschaftsgesetz (Cooperative Societies Act).
[12] §§ 36–41 GenG.
[13] Judgment of *BGH* from 14.07.1980, II ZR 161/79, BGHZ 78, 82, 84; Judgment of *BGH* from 24.11.1980, II ZR 182/79, BGHZ 79, 38, 41; Judgment of *BGH* from 14.11.1983, II ZR 33/83, BGHZ 89, 48, 52; Judgment of *BGH* from 29.05.1989, II ZR 220/88, NJW 1989, 2683; Judgment of *BGH* from 28.10.2002, II ZR 146/02, NJW 2003, 351; Judgment of *OLG Schleswig* from 16.11.2000, 5 U 66/99, NZG 2001, 275 seq.; *Beiner*, Der Vorstandsvertrag, Stuttgart 2005, para 24–26; *Mertens*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 84 para 2; different: *Baums*, Der Geschäftsleitervertrag, Cologne 1987, 3 seq,: *Einheitstheorie* is in contradiction of the phrasing and history of section 84 and lacks significant material advantages.
[14] § 84(1), sentence 1 AktG.
[15] § 108 AktG.
[16] *Mertens*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 84 para 4.

– the articles of associations may provide that a different body, e.g. a facultative supervisory board,[17] has authority to appoint the directors (section 45(2) GmbHG).[18] This body does not have to be constituted by members of the company.[19] Even authorities, creditors, parent companies or other third parties may be granted such a competence.[20]

2.1.2 Who can be *de jure* director

According to section 76(3) sentence 1 AktG[21] only natural persons with unrestricted legal capacity can become board members in a public limited company. Therefore, companies and other legal persons are prohibited from becoming directors in a German public limited company.[22] Furthermore, Section 76(3) sentence 2 AktG stipulates three negative prerequisites. Directors shall not be:

– persons under custodianship[23] (no. 1);
– persons who are subject to a judicial order not to exercise an occupation in the same line of business as the enterprise – professional ban (no. 2);
– persons convicted of certain crimes for a period of five years from their conviction (no. 3).

These persons are not allowed to become a company director. Though nationality and place of residence of the director are irrelevant, the director must be entitled to enter Germany.[24] In addition, the director shall not be a member of the supervisory board (section 105(1) AktG). Neither the Federal President nor members of the Federal Government can be directors (Articles 55(2), 66 Basic Law (GG)).

The director can be a shareholder, though, following the principle of external representation (*Prinzip der Fremdorganschaft*), he is not required to own any stock.

The law does not impose a minimum or maximum age to become a director, although such age limitations may be laid down in the company's articles. Furthermore, personal suitability prerequisites can be provided for in the articles, as long as the supervisory board retains discretion in selecting the management board members.[25] Whether the supervisory board has authority to act against the

[17] Judgment of *BGH* from 25.02.1965, II ZR 287/63, BGHZ 43, 261, 264; Judgment of *BGH* from 02.07.1973, II ZR 94/71, WM 1973, 1295.
[18] *Hueck/Fastrich*, in: Baumbach/Hueck, GmbH-Gesetz, 19th edition, Munich 2010, § 6 para 30.
[19] *Michalski/Heyder,* GmbHG, 2nd edition, Munich 2010, § 45 para 60; *Roth/Altmeppen*, GmbHG, 6th edition, Munich 2009, § 45 para 27; *Rowedder/Schmidt-Leithoff*, 5th edition, Munich 2011, § 45 para 28.
[20] Instead of many: *Beuthien/Gätsch*, ZHR 157 (1993), 483, 492 seq.& *Hueck/Fastrich*, in: Baumbach/Hueck, GmbH-Gesetz, 19th edition, Munich 2010, § 6 para 31 fn 65; differing: *Ulmer*, in: FS Werner, Berlin 1984, 911 seq. & 919 seq.; *Ulmer*, in: Großkommentar GmbHG, Tübingen 2005, § 3 para 44; *Schneider*, in: Scholz, 10th edition, Cologne 2010, § 46 paras 49 seq. & § 38 para 24–25 & § 52 para 222; Schmidt*,* in: Scholz, 10th edition, Cologne 2010, § 46 para 72; Teichmann, Gestaltungsfreiheit in Gesellschaftsverträgen, Munich 1970, 196.
[21] "Mitglied des Vorstands kann nur eine natürliche, unbeschränkt geschäftsfähige Person sein." – *Member of the executive committee can only be a natural person with unrestricted legal capacity.*
[22] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 76 AktG, para 25.
[23] §§ 1896 seq., 1903 BGB.
[24] For the limited liability company: Judgment of *OLG Frankfurt* from 22.02.2001, 20 W 376/2000 FGPrax 2001, 124 seq.; Judgement of *OLG Hamm* from 09.08.1999, 15 W 181/99, NJW-RR 2000, 37, 38; Judgment of *OLG Köln* from 30.09.1998, 2 Wx 22/98, GmbHR 1999, 182, 183; Judgment of *LG Rostock* from 22.12.2003, 5 T 9/03, NJW-RR 2004, 398 seq.; *Teichmann*, IPRax 2000, 110, 113–114; differing: Judgment of *OLG Dresden* from 05.11. 2002, 2 U 1433/02, NZG 2003, 628, 629.
[25] *Geßler,* in: FS Luther, Munich 1976, p. 69, 82; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 76 AktG, para 26; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 84 AktG, para 27.

requirements laid down in the articles is disputed.[26] Case law on this issue does not exist, but it has been argued in the literature that granting the supervisory board such wide discretion would disregard the significance and importance of the articles.[27]

The limited liability company is governed by the same rules as the public limited company. The applicable rules can be found in Section 6(2), (3) GmbHG. The limited company may be established with one or more directors. In contrast to company law, partnership law is based on the principle of self-management and self-representation (*Prinzip der Selbstorganschaft*),[28] meaning that only the partners have the right to represent and act on behalf of the enterprise.

2.2 De facto and shadow directors

2.2.1 De facto director

Persons who perform duties as a *de jure* director but do not meet the legal requirements for the appointment as a director are called *de facto* directors. A person may be regarded as a *de facto* director in the following circumstances:

- the person acts as a director without any act of appointment; or
- the appointment of the actual director is void, but the person acts as a director.

Both situations have the same three requirements: firstly, the *de facto* director has not been legally appointed as director; secondly, he or she acts as a *de jure* director; thirdly, other directors and/or employees act according to the *de facto* director's instructions. The factors that should be taken into account to decide on the existence of a *de facto* director include the intensity and duration of his or her influence[29] and the performance of acts that are functionally part of a director's role.[30] It is not sufficient merely to influence the *de jure* director. Rather, the *de facto* director must manage the company in a way as a *de jure* director would perform his or her duties, i.e. the director must (also) act externally in relation to third parties.[31] It has been held that legal persons cannot be *de facto* directors.[32]

2.2.2 Shadow director

A shadow director is firstly not a *de jure* director. As opposed to the *de facto* director, she does not take part in the company's governance openly. Nevertheless, she instructs and directs the actual directors and these instructions and directions are complied with.

[26] *Hommelhoff*, BB 1977, 322, 324–325; *Lutter/Krieger*, Rechte und Pflichten des Aufsichtsrats, 5th edition, Cologne 2008, § 7 para 340; *Mertens*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 76 para 117.
[27] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 76 AktG, para 26.
[28] This principle is laid down, for example, in §§ 114, 125 Commercial Code (HGB).
[29] Judgment of *BGH* from 21.03.1988, II ZR 194/87, BGHZ 104, 44, 48; Judgment of *BGH* from 27.06.2005, II ZR 113/03, ZIP 2005, 1414, 1415. *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 192.
[30] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 193.
[31] Judgment of *BGH* from 25.02.2002, II ZR 196/00, BGHZ 150, 61; Judgment of *BGH* from 27.06.2005, II ZR 113/03, ZIP 2005, 1414; Judgment of *KG* from 23.05.2000, 14 U 6481/98, KG NZG 2000, 1032, 1033.
[32] Judgment of *BGH* from 25.02.2002, II ZR 196/00, BGHZ 150, 61, 70.

3 THE SCOPE OF DIRECTORS' DUTIES UNDER GERMAN LAW

3.1 Types of directors' duties

3.1.1 Public limited company

In order to understand the scope of directors' duties in German public limited company law, it is necessary to examine its central provision, section 93(1) AktG. This section does not only provide a standard of fault (*Verschuldensmaßstab*), but objective behavioural obligations embodied in sentence 1 of the provision (*objektive Verhaltenspflichten*).[33] Sentence 1 of section 93(1) provides that the members of the management board shall exercise the care of an ordinary and conscientious director in managing the corporation. The provision is commonly interpreted as laying down general and open-ended behavioural expectations (*Generalklausel*) that need to be interpreted in light of the role of the management board to manage the company on its own responsibility,[34] the fiduciary nature of the office of director, and provisions of the Stock Corporation Act laying down specific duties of directors.[35]

The specific duties of the management board and the individual members of the board include the following:

- Changes of the management board and the authority of the board's members to represent the company must be filed for entry in the commercial register, section 81 AktG;
- The management board must carry out lawful resolutions of the general meeting, section 83(2) AktG;
- The members of the management board must not compete with the company, section 88 AktG;
- The management board must report to the supervisory board, section 90 AktG;
- The management board must keep the necessary accounts and records, section 91 AktG;
- The management board must call a general meeting in the case of loss of half of the legal capital, inability of the company to pay its debts, or balance sheet insolvency, section 92 AktG;
- The members of the management board are required to maintain confidentiality, section 93(1) sentence 3 AktG;
- The management board, together with the supervisory board, is required to make a declaration with regard to the corporate governance code, section 161 AktG;
- The members of the management board are required to apply for the opening of insolvency

[33] *Mertens*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 93 paras 6 & 7; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 93 para 20.
[34] § 76(1) AktG.
[35] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 3a.

proceedings if the company becomes insolvent, section 15a(1) Insolvency Act (InsO).

Section 93(1) AktG remains relevant for the following general objective behavioural obligations:

- duty of legality (*Legalitätspflicht*);[36]
- duty of care in a narrow sense (*Sorgfaltspflicht im engeren Sinne*);[37]
- monitoring duties (*Überwachungspflichten*).[38]

In addition, directors have to comply with the duty of loyalty, which applies by virtue of the fiduciary nature of the office of director.[39] Again, it is possible to distinguish between three different aspects of the duty of loyalty:

- duty of loyalty in a narrow sense;[40]
- obligation of confidentiality, as laid down in section 93(1) sentence 3 AktG;[41]
- restraint on competition, section 88 AktG.[42]

These duties apply cumulatively,[43] unless one can be qualified as the *lex specialis* of another (this is the case, for example, with respect to the obligation of confidentiality and the general duty of loyalty).[44]

In general, the duties – and the directors' potential liability – begin when the appointment takes effect[45] and end either with the end of the term of office[46] or an effective revocation of the appointment.[47] However, some duties, such as the duty of loyalty and the obligation of confidentiality, continue to have an effect (*nachwirkende Pflichten*) even after the directorship has come to an end.[48]

3.1.2 Limited liability company

The director of a limited liability company has similar duties as those described above for the public company. The director's primary duty is to manage the company, which is derived from sections 35 and 37 GmbHG. Furthermore, the following duties are specified in statutory law:

- registration of the company, section 7 GmbHG;
- prohibition of the distribution of the company's capital, sections 30, 43 GmbHG;

[36] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 14–40.
[37] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 41–93.
[38] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 94–112.
[39] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 84 para 9 and § 93 para 5.
[40] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 113–159.
[41] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 160–174.
[42] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 88 paras 1–14.
[43] Judgment of the *BGH* from 14.03.1983, II ZR 103/82, NJW 1983, 1856; *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 197.
[44] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 4.
[45] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 12 & § 84 paras 3–4.
[46] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 12 & § 84 paras 6–7.
[47] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 12 & § 84 paras 23 seq.
[48] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 179; *Fleischer*, in: Handbuch des Vorstandsrechts, Munich 2006, § 11 para 14; *Hopt*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 93 para 39; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 93 para 13.

- compliance with limitations of the power to represent the company, section 37 GmbHG;
- duty to keep books and records, section 41 GmbHG;

- duty to inform the members of the company, section 51a GmbHG;
- duty to register capital increases and decrease, section 57f GmbHG;
- duty to apply for the opening of insolvency proceedings if the company becomes insolvent, section 15a(1) Insolvency Act (InsO).
- Duty to call a general meeting in the case of loss of half of the legal capital, section 49(3) GmbHG.

Furthermore, the director of a limited liability company is subject to the duty of loyalty (for details see below 4.2).

3.2 To whom are the duties owed?

The directors' duties are in general owed to the company. For the duty of care, this is expressly provided for by section 93(2) AktG. It has been said that section 93(2) AktG is an expression of the general internal liability organisation of the stock corporation (*innerverbandliche Haftungsordnung*), which also applies to the duty of loyalty.[49]

The interests of the company that the directors are required to protect and promote are diverse. The directors have to balance the different interests that constitute the company's interest (*Unternehmensinteresse*, which can be translated as "enterprise interest"),[50] applying the so-called principle of "practical concordance", which is a general method in German law to reconcile conflicting interests.[51] The enterprise interest is equivalent to the "welfare of the company" (*Wohl der Gesellschaft*), which is mentioned in section 93(1) sentence 2 AktG,[52] the "company's interest" (*Gesellschaftsinteresse*) in section 3(3) Securities Acquisition and Takeover Act (WpÜG), and "the benefit of the enterprise" (*Unternehmenswohl*) in Section 3.1 of the German Corporate Governance Code.[53] The jurisprudence of the Federal Court of Justice is in line with this interpretation, although decisions only exist with respect to section 93 AktG.[54]

The German regime in a nutshell is the following: Directors are not obliged to act *only* in the interest of the shareholders, *as long as* they secure the company's profitability in the long run.[55] According to

[49] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 118.
[50] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 76 para 15.
[51] *Hommelhoff*, ZGR 2001, 238, 250; *Hopt*, ZGR 1993, 534, 536; *Hopt*, ZGR 2002, 333, 360; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 76 para 12; *Hüffer*, ZHR 161 (1991), 214, 217; *Klöhn*, ZGR 2008, 110, 118; *Kort*, in: Großkommentar zum AktG, 4th edition, Berlin 1999 seq., § 76 para 40; *Raiser*/*Veil*, Recht der Kapitalgesellschaften, 4th edition, Munich 2006, § 14 para 13; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 76 paras 53; *Stein,* ZGR 1988, 163, 189; *v. Werder*, ZGR 1998, 69, 77 sequ.; *Wiesner,* in: Münchener Handbuch des Gesellschaftsrechts, Bd. IV, Aktiengesellschaft, 3rd edition, Munich 2007, § 19 paras 20; *Wilhelm*, Kapitalgesellschaftsrecht, 3rd edition, Berlin 2009, para 1026.
[52] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 AktG para 4g; *Spindler*, NZG 2005, 865, 872.
[53] *Klöhn*, ZGR 2008, 110, 118 seq.
[54] *Fleischer*, in: Fleischer, Handbuch des Vorstandsrechts, Munich 2006, § 1 para 24.
[55] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 76 AktG para 13; *Kort*, in: Großkommentar zum AktG, 4th edition, Cologne 1993 seq., § 76 paras 51–52; *Mertens*, Kölner Kommentar zum AktG, 3rd edition, Cologne 2010, § 76 para 17.

some authors,[56] the interests of stakeholders[57] are to be taken into account. Others give primacy to the interests of the shareholders.[58]

3.3 The director as a shareholder

If the director acts in his or her function as shareholder, the duty of loyalty in a narrow sense[59] obliges the director to act in a way that does not conflict with his or her existing duties as a director. In addition, section 136(1) AktG imposes limits on the director's voting rights (as shareholder) in decisions concerning the discharge of the director, the release of the director from an obligation, or the enforcement of the company's claims against the director.

3.4 Application of duties to *de facto* and shadow directors

It is controversial whether, and under what conditions, directors' duties apply to *de facto* and shadow directors. The courts have held that *de facto* directors can be criminally liable[60] and applied civil liability for the failure to file for the opening of insolvency proceedings to such directors.[61] This jurisprudence is not applicable to shadow directors, since the courts require that the defendant acted in relation to third parties as a director.[62] It is not sufficient that the person influenced the *de jure* directors internally.

In the legal literature, several opinions can be distinguished. Some commentators exclude from the concept of *de facto* director persons who are held out as directors without any formal act of appointment.[63] This view has the consequence that liability can only attach to those who were appointed as directors, albeit in a legally defective way. Other *de facto* directors are not liable, notwithstanding the fact that they manage the company, influence the *de jure* directors, or are otherwise intensively involved in the company's business operations.[64]

Other commentators are in favour of a more inclusive approach and apply directors' duties and liability also to *de facto* directors of the second type (those acting without any appointment, defective or not), provided that they have largely replaced the *de jure* directors.[65]

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[56] *Goette*, in: FS 50 Jahre BGH, Munich 2000, 123, 127; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 76 paras 66–67; *Henze*, BB 2000, 209, 212; *Kort*, in: Großkommentar zum AktG, 4th edition, Berlin 1999 seq., § 76 para 40; *v. Werder*, DB 2002, 801, 804.
[57] *Mertens*, Kölner Kommentar zum AktG, 3rd edition, Cologne 2010, § 76 para 16: only the profit sharing stakeholders. Only shareholders can be investors.
[58] *A. Arnold*, Die Steuerung des Vorstandshandelns, Munich 2007, 43 seq.; *Fleischer*, AG 2001, 171, 177; *Mülbert*, ZGR 1997, 129, 156 seq; *Mülbert*, IStR 1999, 83, 84; *Rittner*, JZ 1980, 113, 117; *Servatius,* Strukturmaßnahmen als Unternehmensleitung, Cologne 2004, 57 seq.; *Zöllner*, AG 2000, 145, 146–147; *Zöllner*, AG 2003, 2, 7–8.
[59] See below: 4.2.1.1.
[60] *RGSt* 16, 269; *BGHSt* 21, 101.
[61] *BGHZ* 75, 96 (*Herstatt*); 104, 44; 150, 61.
[62] *BGHZ* 150, 61.
[63] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 12; *Landwehrmann*, in: Anwaltkommentar zum Aktienrecht, Bonn 2003, § 93 para 4; *Mertens*/*Cahn*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 93 paras 42–43; for the private limited company: *Zöllner*/*Noack*, in: Baumbach/Hueck, GmbHG, 19th edition, Munich 2010, § 43 para 3.
[64] Thus for the private limited company: *Zöllner*/Noack, in: Baumbach/Hueck Baumbach/Hueck, GmbHG, 19th edition, Munich 2010, § 43 para 3.
[65] *Mertens*/*Cahn*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 93 para 43; *Stein*, Das faktische Organ, Berlin 1983, 184 seq.; *Zöllner*/Noack, in: Baumbach/Hueck, GmbHG, 19th edition, Munich 2010, § 43 para 3.

A third opinion argues that anyone who actually manages the company[66] or influences the *de jure* directors,[67] i.e. all types of *de facto* director irrespective of the appointment process,[68] are liable for a breach of directors' duties pursuant to sections 93(2) AktG, 43(2) GmbHG. Within this opinion, some hold that the approval (*Billigung*) by the supervisory board or the shareholders is a condition for the application of directors' duties to *de facto* directors, although an explicit decision is not required.[69] Others argue that the knowledge of the appointing body is sufficient.[70] A borderline case is the consent of the supervisory board's chairman without the supervisory board's authorisation.[71]

[66] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 187–188: acting like a director in a director-like way; *Hopt*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 93 para 49.
[67] *Schneider*, in: Scholz, 10th edition, Cologne 2010, § 43 para 22; in detail: *Krebs*, Geschäftsführerhaftung, Geschäftsführungshaftung bei der GmbH & Co. KG und das Prinzip der Haftung für sorgfaltswidrige Leitung, Baden-Baden 1991, 174 seq.
[68] *Hopt*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 93 para 45; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 93 para 14; for the private limited company: *Schneider*, in: Scholz, 10th edition, Cologne 2010, § 43 para 22; with regard to the delayed filing of insolvency: *Schmidt*, in: Scholz, 10th edition, Cologne 2010, § 64 para 7.
[69] *Hopt*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 93 para 50; opposing to such a requirement: *Stein*, ZHR 148 (1984), 207, 216; *Schmidt*, in: Scholz, 10th edition, Cologne 2010, § 64 para 7.
[70] *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 93 para 14.
[71] *Hopt*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 93 para 50; for the wrongly appointed director: *Baums,* Der Geschäftsleitervertrag, Cologne 1987, 58.

4 LIABILITY FOR BREACH OF DUTY

According to section 93(2) sentence 1 AktG, directors are jointly and severally liable to the company to pay damages under the following conditions: They must have breached a duty, acted in a culpable way, and caused damage to the company.[72] Furthermore, section 93(3) AktG lists nine specific cases of a breach of duty. Subsection 3 is considered to be a separate basis for a cause of action of the company.[73] The importance of the provision is that it establishes a rebuttable presumption that the company has sustained a loss to the extent that the directors have distributed or committed the company's assets as described in subsection 3. Thus, section 93(3) AktG modifies the general rule that the company bears the burden of proving that it has sustained a loss.

The damages claim is vested in the company (however, creditors of the company are entitled to enforce the claim pursuant to section 93(5) sentence 1 AktG if they are unable to obtain satisfaction from the company). A direct claim of the shareholders only exists pursuant to section 117(1) sentence 2 AktG if the directors intentionally use their influence on members of the management or supervisory board or other persons authorised to represent the company in a way detrimental to the company or its shareholders. Shareholders are generally not able to base a direct claim for damages on tort law, since German tort law does not contain a general provisions comparable to Art. 1382 of the French Code Civil.[74]

4.1 Duty of care pursuant to section 93(1) AktG: conditions for liability

4.1.1 The behaviour covered

Within the duty of care as laid down in section 93(1) AktG, it is possible to distinguish between three different duties: the duty of legality,[75] the duty of care in a narrow sense,[76] and the duty to monitor and supervise.[77]

4.1.1.1 Duty of legality

The duty of legality requires the directors to abide by the law while acting for the company.[78] The duty has an internal and an external aspect. The former consists of the corporate duties of directors as laid down in the Stock Corporation Act, the articles of association and the by-laws. The external aspect

[72] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 AktG paras 13-15.
[73] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 225.
[74] § 823(1) BGB deals with specific types of damage (injury to life, body, health, freedom, property, but not general financial damage). § 823(2) BGB, which provides that a person is liable to pay damages if that person "commits a breach of a statute that is intended to protect another person", does not apply to the breach of directors' duties because section 93(2) AktG is held not to be "a statute that is intended to protect another person". See *Kau/Kukat*, BB 2000, 1045, 1046. Finally, § 826 of the German Civil Code (BGB) is restricted to intentional behaviour contrary to public policy.
[75] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 14–40.
[76] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 41–93.
[77] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 94–112; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 93 para 82.
[78] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 14; *Mertens*, Kölner Kommentar zum AktG, 3rd edition, Cologne 2010, § 93 para 30.

derives from various statutes other than the Stock Corporation Act, e.g. the Civil Code (BGB) or the Commercial Code (HGB). Some authors[79] additionally require the directors to comply with commonly accepted principles of business ethics (*anerkannte Grundsätze der Geschäftsmoral*). However, this view is not widely accepted, since the content of the principles of business ethics are not well defined, thus giving rise to legal uncertainty.[80]

4.1.1.2 Duty of care in a narrow sense

The second duty, the duty of care in a narrow sense,[81] has again four different aspects.

First, the duty to plan and control the business (*Planungs- und Steuerungsverantwortung*). A facet of this duty can be found in section 90(1) sentence 1 no. 1 AktG. According to this provision, the directors have to inform the supervisory board about important matters of business policy. The objective of the duty is to ensure an orderly planning of the company's finances, capital investment and human resources. In general, setting the relevant parameters is in the discretion of the board.[82] In order to fulfil the duty, a suitable control mechanism[83] is needed that facilitates gathering the relevant business data and makes certain that undesirable developments are identified.[84]

Secondly, the directors have organisational responsibilities (*Organisationsverantwortung*), requiring them to establish an organisational structure that is in compliance with the applicable laws and the articles of association.[85] Again, the directors enjoy some discretion how to fulfil the duty.[86]

Thirdly, the financial responsibilities of the directors (*Finanzverantwortung*) comprise the duty to safeguard the company's liquidity by means of adequate financial planning[87] and establish structures enabling the directors to assess the financial situation at any time.[88]

Finally, the director's informational responsibilities (*Informationsverantwortung*) require them to set up structures that ensure the flow of information.[89]

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[79] *Landwehrmann*, in: Anwaltkommentar zum Aktienrecht, Bonn 2003, § 93 para 23; *Mertens*, Kölner Kommentar zum AktG, 3rd edition, Cologne 2010, § 93 para 34.

[80] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 25.

[81] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 41–93.

[82] *Altmeppen*, ZGR 1999, 291, 305; *Fedderson*, ZGR 1993, 114, 116 seq.; *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 53; *Kropff*, NZG 1998, 613 seq.

[83] BegrRegE for KonTraG, BT-Drs. 13/9712, 15; *Ballwieser*, in: Handbuch Corporate Governance, 429 & 435; *Gernoth*, DstR 2001, 299, 300; *Hopt*, in : Großkommentar, 4th edition, Berlin 1999 seq., § 93 paras 84 & 107.

[84] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 55.

[85] *Hopt*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 93 paras 89 & 107; *Mertens*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 93 paras 30 & 45.

[86] *Landwehrmann*, in: Anwaltkommentar zum Aktienrecht, Bonn 2003, § 93 para 55.

[87] *Groß/Amen*, Wpg 2003, 1161, 1175.

[88] Judgment of *BGH* from 20.02.1995, II ZR 9/94, NJW-RR 1995, 669 seq; *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 57.

[89] *Fleischer*, ZIP 2003, 1, 5.

4.1.1.3 Monitoring duty

The third set of duties derived from section 93(1) AktG are monitoring duties.[90] These duties have a horizontal and a vertical aspect. The horizontal aspect refers to the overall responsibility of the board members to monitor all business transactions, even those that do not fall within their scope of activity.[91] In order to fulfil this duty, each director needs to obtain access to the relevant information. Thus, he or she has a right to information.[92] The vertical aspect of the monitoring duties refers to the delegation of duties. If a director delegates duties, he or she is required to choose the person to whom the duties are delegated carefully, instruct and monitor the person.[93]

4.1.2 Conditions for liability

4.1.2.1 Directorship

To be liable, the defendant has to be a company director. The director is subject to directors' duties from the time when the appointment takes effect;[94] the conclusion of the employment contract is irrelevant. A legally defective appointment is sufficient, provided that the director has acted on the basis of the appointment for the company.[95] The director is no longer bound by directors' duties when the term of office ends or the appointment is revoked and the director ceases to act for the company.[96] If the director continues to manage the company after the end of his or her term of office, some commentators hold that he or she continues to be subject to directors' duties and may be liable.[97] Others reject liability in such a case.[98]

With the director's resignation, the general objective behavioural obligations normally come to an end.[99] However, resignation at an inappropriate time may constitute an independent breach of duty.[100]

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[90] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 94–112; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 93 para 82.
[91] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 77 para 15; *Mertens*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 77 para 18.
[92] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 95.
[93] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 101–111.
[94] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 12 & § 84 paras 3–4.
[95] Judgment of the *RG* from 05.06.1934, II 59/34, RGZ 144, 384, 387; Judgment of the *RG* from 09.10.1936, II 43/36, RGZ 152, 273, 277; Judgment of the *BGH* from 06.04.19964, II ZR 75/62, BGHZ 41, 282, 287; *Baums*, Der Geschäftsleitervertrag, Cologne 1987, 168 seq.; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 12; *Mertens*, Kölner Kommentar zum AktG, 3rd edition, Cologne 2010, § 93 para 11; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 93 paras 11 & 14.
[96] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 12 & § 84 paras 23 seq.
[97] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 12 & § 84 paras 6–7.
[98] Judgment of the *RG*, SeuffA 93, 310, 312; Judgment of the BGH of 17.04.1967, II ZR 157/64, BGHZ 47, 341, 343; *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 179; *Hopt*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 93 para 38; *Mertens*, Kölner Kommentar zum AktG, 3rd edition, Cologne 2010, § 93 para 10 *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 93 para 11.
[99] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 84 paras 24 & 36, § 93 AktG para 13.
[100] Judgment of *OLG Koblenz* from 26.05.1994, 6 U 455/9, NJW-RR 1995, 556 seq.; *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 179; *Hopt*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 93 para 40.

4.1.2.2 Breach of duty

Secondly, the director must have breached his or her duty. This can be any duty, deriving either from specific or general obligations.[101] The horizontal allocation of functions between different board members does not have the effect that the directors are only responsible for their field of business. Rather, as discussed above, the duty of care is transformed into the duty to monitor the careful discharge of the directors' functions by all board members.[102]

4.1.2.3 Acting in a culpable way

Thirdly, the director must have acted in a culpable way. Section 93 AktG lays down a negligence standard; any type of negligence is sufficient.[103] In line with general principles of negligence, incompetence, lack of expertise or knowledge does not exculpate the director.[104] An intention to harm the company is not necessary.[105] However, the director is only liable for his or her own fault, not for the negligent conduct of fellow board managers. Directors are not agents of other board members; the principles of vicarious liability, therefore, do not apply.[106] Contributory negligence (*Mitverschulden*)[107] is not a defence, as this would be inconsistent with the idea of a joint guarantee that can be derived from section 93 AktG.[108]

The standard of care is qualified by section 93(1) sentence 2 AktG, the German business judgement rule. This rule was initially developed by the Federal Court of Justice in the seminal *ARAG/Garmenbeck* decision[109] and codified in 2005.

4.1.2.4 Damage to the company

Fourthly, the company must have sustained a loss. The amount of damages is calculated according to general principles of civil law.[110] The situation after the damaging act is compared with the hypothetical situation that would have obtained had the act not occurred.

As mentioned above, within the scope of application of section 93(3) AktG, it is presumed that the reduction in the company's assets resulting from the challenged conduct is identical with the damage sustained by the company.[111]

[101] Overview: *Ihlas*, Organhaftung und Haftpflichtversicherung, Berlin 1997, 74 seq.
[102] See above: 4.1.1.3.
[103] *Baums*, Der Geschäftsleitervertrag, Cologne 1987, 211; *Hopt*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 93 para 253; *Peltzer*, in: FS Hadding, Berlin 2004, 593.
[104] Judgment of the *RG* from 28.02.1940, II 115/39, RGZ 163, 200, 208; *Landwehrmann*, in: Anwaltkommentar zum Aktienrecht, Bonn 2003, § 93 para 106.
[105] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 209.
[106] Judgment of the *BGH* from 31.03.1954, II ZR 57/53, BGHZ 13, 61, 65; *Fleischer*, NZG 2003, 449, 553; *Hopt*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 93 para 55;
[107] Regulated in sections 31, 254 Civil Code (BGB).
[108] Judgment of the *BGH* from 14.03.1983, II ZR 103/82, NJW 1983, 1856; Judgment of the *BGH* from 20.03.1986, II ZR 114/85, WM 1986, 789.
[109] Judgment of the *BGH* from 21.04.1997, II ZR 175/95, BGHZ 135, 244 seq.
[110] §§ 249 seq. Civil Code (BGB).
[111] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 AktG para 22.

Furthermore, a causal connection is required between the breach of duty and the damage. German law applies the theory of adequate causation, i.e. it is not sufficient that the damage would not have occurred but for the challenged conduct (*conditio-sine-qua-non formula*), but the claimant has to show that the damage was to be expected in light of the circumstances.

The directors can defend themselves by showing that the damage could not have been avoided even if they had acted in a duty-compliant way.[112] However, in the case of collective decision-making, i.e. by resolution of the board, it is not permissible to claim that the decision would also have been adopted if the defendant director had abstained from voting since the required majority for adoption of the resolution was guaranteed. Such an argument would run counter the principle expressed in section 93(2) AktG that the board members are both individually and collectively (as an organ of the company) responsible to act in compliance with directors' duties.[113]

4.1.3 Burden of proof

The company bears the burden of proving three requirements (section 93(2) AktG): that the challenged act of the defendant constitutes a breach of duty, the company has sustained a loss, and a causal connection exists between the breach of duty and the loss.[114]

The defendant director must show that he or she exercised the care of a diligent and conscientious manager, as set out in section 93(2) sentence 2 AktG. The burden of proof is shifted because the defendant director is in a better position than the claimant to obtain and present the facts necessary to assess the level of care employed by him or her.[115] This rule applies to all board members independent of their position on the board, including retired board members who are able to obtain the relevant information pursuant to section 810 of the Civil Code (BGB),[116] and to cases implicating the duty of loyalty.[117]

4.2 Duty of loyalty: conditions for liability

The duty of loyalty is not explicitly regulated in section 93 AktG. Although several provisions of the German Corporate Governance Code deal with the duty of loyalty,[118] it is rather fragmented compared to other jurisdictions.[119]

We can again distinguish between three different aspects of the duty: first, the duty of loyalty in a narrow sense, secondly the obligation of confidentiality pursuant to section 93(1) sentence 3 AktG, and thirdly the restraint on competition as laid down in section 88 AktG.

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[112] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 216; *Mertens*, Kölner Kommentar zum AktG, 3rd edition, Cologne 2010, § 93 para 23.
[113] Judgment of the *BGH* from 14.03.1983, II ZR 103/82, NJW 1983, 1856; *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 218.
[114] Judgment of the BGH from 04.11.2002, II ZR 224/00, BGHZ 152, 282, 284; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 AktG para 16; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 93 para 98.
[115] Judgment of the BGH from 04.11.2002, II ZR 224/00, BGHZ 152, 282, 283; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 93 para 86.
[116] Right to inspect documents.
[117] *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 93 para 89.
[118] Sections 4.3.1-4.3.5.
[119] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 102. For the opposing view see *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 AktG para 17; *Rieger*, in: FS Peltzer, Cologne 2001, 339, 351.

4.2.1 The behaviour covered

4.2.1.1 Duty of loyalty in a narrow sense

The duty of loyalty in a narrow sense encompasses five types of behaviour.

First, the board member has to employ his or her knowledge, abilities and experience without reservation for the benefit of the company.[120]

The second type of cases implicating the duty of loyalty is self-dealing, i.e. transactions of the director with his or her company. In order to address the conflict of interest that exists when the director stands on both sides of the transaction, the law provides for a shift of decision-making power from the management board to the supervisory board (section 112 AktG).[121] By way of an exception to the general provision vesting authority to represent the company in the management board,[122] section 112 AktG provides that the supervisory board represents the company in dealings with members of the management board. This provision is *ius cogens* and cannot be waived or amended by the articles of association.[123]

Thirdly, the duty of loyalty regulates corporate opportunities. According to the corporate opportunities doctrine (*Geschäftschancenlehre*), directors are prohibited from making use of corporate opportunities for their own benefit.[124] This rule is not explicitly laid down in section 93 AktG or elsewhere in the Stock Corporation Act, but it is well established and also mentioned in the German Corporate Governance Code.[125]

Fourthly, the duty of loyalty prohibits the director from expropriating company assets or using the company's resources for private purposes.[126]

Finally, directors are not allowed to accept any benefits form third parties, either for themselves or others.[127]

4.2.1.2 Obligation of confidentiality, section 93(1) sentence 3 AktG

Pursuant to section 93(1) sentence 3 AktG, board members are required not to disclose confidential information and business secrets of the company. Confidential information can be any information that the board member obtained due to his or her holding office. It is neither necessary that the director

[120] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 128 with a enumeration of various cases in fn 507–514; for the private limited company: *Schneider*, in: Scholz, 10th edition, Cologne 2010, § 43 para 155.
[121] Judgment of *BGH* from 08.02.1988, II ZR 159/87, BGHZ 103, 213, 216–217; *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 134; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 112 para 1.
[122] § 78 AktG.
[123] *Hübner*, Interessenkonflikt und Vertretungsmacht, Munich 1977, 230.
[124] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 137 with numerous decisions of the BGH in fn 558.
[125] Section 4.3.3.
[126] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 153 with numerous decisions of the BGH in fn 637–647.
[127] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 155 with numerous decisions of the BGH in fn 648–651. See also Section 4.3.2 German Corporate Governance Code.

generated or accessed the information by himself nor that the information is declared to be confidential.[128] Business secrets are facts that are, and should be, kept confidential due to an objective necessity not to disclose them.[129] This includes, for example, manufacturing processes, financial and production plans, or personnel decisions.[130] As the obligation applies to all board members, it does not require the directors to keep information confidential in relation to their fellow board members or the supervisory board.[131] In addition, the duty is not breached if a third party is legally entitled to obtain the information.[132]

4.2.1.3 Restraint on competition, section 88 AktG

Section 88 AktG intends to protect the company against losing board members and to protect it from acts of competition.[133] In so far as acts of competition are concerned, section 88 AktG is an expression of the directors' duty of loyalty.[134]

Section 88 AktG addresses three different aspects of competitive behaviour. First, it prohibits the members of the management board from operating a commercial business without the consent of the supervisory board.[135] Secondly, members of the management board are not allowed to enter into transactions in the line of business of the company for their own account or on behalf of third parties.[136] Relevant is the company's actual line of business and not the objects as laid down in the articles of association.[137] Thirdly, directors are prohibited from being members of the management board, managing director, or managing partner of another company without the consent of the supervisory board.[138] The line of business of the other company, or any actual competition with the director's company, is irrelevant. However, members of the management board are permitted to join the supervisory board of another company or become shareholders, as long as they do not have any management obligations.[139]

4.2.2 Conditions for liability

4.2.2.1 Duty of loyalty in a narrow sense and obligation of confidentiality

Both the duty of loyalty in a narrow sense and the obligation of confidentiality according to section 93(1) sentence 3 AktG are general behavioural obligations that apply to all board members. A

[128] Regierungsbegründung bei Kropff, 122–123; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 7.
[129] Judgment of the *RG* from 22.11.1935, II 128/35, RGZ 149, 329, 334; Judgment of the *BGH* from 05.06.1976, II ZR 156/73, BGHZ 64, 325, 329.
[130] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 7.
[131] Judgment of the *BGH* from 26.03.1956, II ZR 57/55, BGHZ 20, 239, 246; Judgment of the *BGH* from 06.03.1997, II ZB 4/96, BGHZ 135, 48, 56.
[132] See, for example, section 93(1) sentence 4 AktG. For more details see *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 93 para 8.
[133] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 88 para 1.
[134] Judgment of the *OLG Frankfurt* from 05.11.1999, 10 U 257/98, NZG 2000, 738 seq.
[135] § 88(1) sentence 1 AktG.
[136] § 88(1) sentence 1 AktG.
[137] Judgment of the *BGH* from 21.02.1978, KZR 6/77, BGHZ 70, 331, 332–333; Judgment of the *BGH* from 05.12.1983, II ZR 242/82, BGHZ 89, 162, 170; *Armbrüster*, ZIP 1997, 1269, 1270; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 88 para 14.
[138] § 88(1) sentence 2 AktG.
[139] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 88 para 4.

breach of any aspect of these duties may lead to liability pursuant to section 93(2) AktG.[140] In general, the same conditions for liability apply as in the case of the duty of care.[141]

The duties begin when a director is appointed. However, they do not necessarily end when the director ceases to hold office, as both variants of the duty of loyalty entail continuing obligations (*nachwirkende Pflichten*).[142]

As far as self-dealing is concerned, section 4.3.4 German Corporate Governance Code provides that "[a]ll transactions between the enterprise and the members of the Management Board as well as persons they are close to or companies they have a personal association with must comply with standards customary in the sector". Thus, self-dealing transactions are required to be fair and reasonable.[143] The relevant test is whether the company would have concluded a similar contract in an arms-length transaction.[144] If not, the director has breached the duty of loyalty.

A commercial opportunity belongs to the company when the company has already entered into negotiations with respect to the opportunity or it is connected with the company's line of business, without necessarily falling directly within that line of business. According to case law and the majority of the legal literature it is irrelevant whether the company has the financial means to take advantage of the business opportunity. Furthermore, it is irrelevant whether the director learns of the opportunity in his capacity as company director or in his private capacity.[145]

As far as the prohibition to accept benefits from third parties is concerned, it is not necessary to show that the company has sustained damage. The claim is not directed at the payment of damages; rather, the director has to disgorge the benefits received.[146]

4.2.2.2 Restraint on competition, section 88 AktG

Section 88(2) sentence 1 AktG entitles the company to claim damages from the director who violates the duty not to compete with the company. Alternatively, the company may assume the contract and require the director to account for the profits made under the contract.

In general, the duties pursuant to section 88 AktG do not continue to bind the director after the term of office ends or the director resigns. However, according to the majority view in the legal literature this

140 *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 200.
141 See above: 4.1.2.
142 *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 179; *Fleischer*, in: Handbuch des Vorstandsrechts, Munich 2006, § 11 para 14; *Hopt*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 93 para 39; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 93 para 13.
143 *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 134; *Hopt*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 93 para 159; *Thoma*, Eigengeschäfte des Vorstands mit der Aktiengesellschaft, Franfurt 2003, 191; *Wiedemann*, Organverantwortung und Gesellschafterklagen in der Aktiengesellschaft, Opladen 1989, 16 seq.; differing: *Fleck*, in: FS Heinsius, Berlin 1991, 89, 97.
144 *Fleischer*, WM 2003, 1045, 1052; *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 135 with cases in fn 547–549.
145 *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 140 seq. with numerous decisions of the BGH.
146 Judgment of *BGH* from 02.04.2001, II ZR 217/99, NJW 2001, 2476, 2477; Judgment of *OLG Düsseldorf* from 25.11.1999, 6 U 146/98, WM 2000, 1393, 1397; *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 155.

may be different if the director did not have a legitimate reason for resigning.[147] Revocation of the appointment without termination of the employment contract also does not terminate the restraint on competition as long as the company continues to pay the board member.[148]

In order to claim damages, the company has to show that the director acted with fault (negligence). This is not expressly stated in section 88, but commonly required in order to achieve consistency with section 93(2) AktG.[149] It is generally also argued that the reversal of the burden of proof pursuant to section 93(2) AktG applies in this context, so that the defendant director has to show due diligence in order to exculpate himself or herself.[150]

As regards the alternative remedy pursuant to section 88 AktG, assumption of the director's contract and accounting for profits, it is controversial whether the director has to have acted culpably.[151] As the remedy (disgorgement of profits) is close to the German law of unjust enrichment, which is not based on any requirement of fault, such a condition is difficult to justify.[152]

Finally, the duty is not violated if the supervisory board gives its consent. It should be noted that the consent cannot be in the form of a blanket approval, but has to specify which trading activities are being approved. An implied consent is not sufficient.[153]

4.2.3 Burden of proof

Breach of the duty of loyalty leads to damages in accordance with section 93(2) AktG,[154] so that in general the same rules regarding the burden of proof apply.[155]

In the case of receipt of benefits from third parties, the courts have held that it can be assumed that related transactions would have been concluded under terms more favourable to the company if the benefits had not been granted. *Prima facie*, therefore, the company has sustained damage at least in the amount of the benefits.[156]

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[147] *Kort*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 88 para 112; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 88 para 9; dissenting while reducing entitlement to an abuse of legal right: *Armbrüster*, ZIP 1997, 1269, 1271; *Mertens*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 88 para 5.

[148] *Mertens*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 88 para 5; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 88 para 9; doubtful as the company does not need the manpower any longer: *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 88 para 2.

[149] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 88 para 6; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 88 para 28.

[150] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 88 para 6; *Mertens*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 88 para 15; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 88 para 28; dissenting: *Golling*, Sorgfaltspflicht und Verantwortlichkeit, Cologne 1969, 43–44.

[151] Affirmative: *Seibt*, in: K. Schmidt/Lutter, Cologne 2007, § 88 para 13; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 88 para 31; in the negative: *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 88 para 37; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 88 para 7.

[152] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 88 para 7.

[153] *Mertens*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 88 para 11; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 88 para 23.

[154] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 200.

[155] See above: 4.1.4.

[156] Judgment of *BGH* from 26.03.1962, II ZR 151/60, WM 1962, 578, 579; Judgment of *OLG Düsseldorf* from 25.11.1999, 6 U 146/98, WM 2000, 1393, 1397; *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 155; *Schneider*, in: Scholz, 10th edition, Cologne 2010, § 43 para 112; in so far an atypic situation: Judgment of *BGH* from 02.04.2001, II ZR 217/99, NJW 2001, 2476, 2477.

4.3 Exemptions and limitations

4.3.1 Duty of care

Exemptions from liability cannot be provided for in the articles of association or the directors' employment contract because section 93(2) AktG is *ius cogens*.[157] However, liability does not arise if the act causing the damage was based on a resolution passed by the general meeting (section 93(4) sentence 1 AktG). Pursuant to section 93(4) sentence 3 AktG, the company can only waive the claim by resolution of the general meeting three years after the claim came into existence, and only if a majority holding 10 percent of the legal capital does not object.

4.3.2 Duty of loyalty

In general, the same exemptions apply as described above for the duty of care. In addition, the following points should be noted.

As regards self-dealing, the prevailing opinion in the literature argues that the prohibition is strict and no *de minimis* exemption should be accepted.[158] However, the supervisory board may dispense the directors from the prohibition with respect to everyday transactions.[159]

The obligation of confidentiality is *ius cogens*, and as such it is not possible to provide for limitations or exemptions.[160]

The restraint on competition (section 88 AktG) does not apply if the supervisory board gives its consent before the director engages in the competitive conduct.[161] *Ex post* authorisation, however, is not sufficient to cure the breach of duty. At this point, the claim for damages has already come into existence and cannot be extinguished by action of the supervisory board (section 93(4) sentence 2 AktG).[162]

4.4 Insurance against liability

D&O insurance is available for board members (see section 93(2) sentence 3 AktG). The company is contracting partner, policy holder and premium debtor. However, the insured board members have a

[157] This follows from section 23(5) AktG (principle of limited contractual freedom, *Prinzip der Satzungsstrenge*). See *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 paras 3–5.
[158] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 135; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 112 para 3; dissenting: *Wiedemann*, Organverantwortung und Gesellschafterklagen in der Aktiengesellschaft, Opladen 1989, 19.
[159] Judgment of *OLG Stuttgart* from 20.03.1992, 2 U 115/90, AG 1993, 85, 86; *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 122; *Hübner*, Interessenkonflikt und Vertretungsmacht, Munich 1977, 249; *Mertens*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 112 para 15; *Semler*, in: FS Rowedder, Munich 1994, 441 450; *Thoma*, Eigengeschäfte des Vorstands mit der Aktiengesellschaft, Frankfurt 2003, 178.
[160] Judgment of *BGH* from 05.06.1975, II ZR 156/73, BGHZ 64, 325, 326; *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 162.
[161] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 88 para 5; dissenting: *Meyer-Landrut*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 88 para 5.
[162] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 88 para 5.

direct right against the insurance company.[163] Section 93(2) sentence 3 AktG stipulates that the insurance contract must provide for excess of at least 10 percent of the damage, but not more than one and a half times the director's fixed annual remuneration.

4.5 Consequences of liability

4.5.1 Duty of care

Pursuant to section 93(2), (3) AktG, the company can claim damages in case of breach of the duty of care. Board members are jointly and severally liable.[164]

4.5.2 Duty of loyalty

4.5.2.1 Duty of loyalty in a narrow sense

A breach of the duty of loyalty in a narrow sense has the consequence that the director is liable to pay damages or, in case of the receipt of benefits from third parties, to disgorge the benefits.

4.5.2.2 Obligation of confidentiality

Any breach of the duty of confidentiality entails damages pursuant to section 93(2) sentence 1 AktG. In addition, the disclosure of a company secret constitutes a criminal offence according to section 404(1) no. 1 or 404(2) AktG.

4.5.2.3 Restraint on competition

As discussed, the company has the choice between damages and assumption of the contract entered into by the director in breach of the duty not to compete with the company (section 88 AktG). It is controversial whether the company can switch from claiming damages to assuming the contract and requiring the director to account for the profits,[165] and vice versa.[166]

[163] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 230.
[164] Joint and several liability is regulated in §§ 421 seq. Civil Code (BGB).
[165] Any shift is possible: *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 88 paras 6, 7.
[166] Shift from assumption of contract to claiming damages is impossible: with an argument based on an analogy to section 263(2) BGB: *Mertens*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 88 para 15; dissenting: *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 88 para 39; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 88 para 6; *Kort*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 88 para 96; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 88 para 29.

5 Duties in the vicinity of insolvency

5.1 The meaning of 'vicinity of insolvency'

A company enters into the vicinity of insolvency when a loss occurs that leads to the duty to notify the general meeting according to section 92(1) AktG. The period ends when the directors are required to apply for the opening of insolvency proceedings pursuant to section 15a InsO.

5.2 Change of existing and newly arising duties

If the company is in financial distress or becomes insolvent, four additional duties arise that are related to the general duty to monitor the financial position of the company[167] and protect the company's assets.[168]

These are:

- The duty to call a general meeting and inform the meeting of a loss amounting to half of the share capital (section 92(1) AktG);
- The prohibition to make payments, unless such payments are compatible with the diligence of a prudent and conscientious manager (section 92(2) sentence 1 AktG), in order to secure the orderly and equitable payment of all creditors;
- The prohibition to make payments to shareholders, if such payments would lead to the company's inability to pay its debts (section 92(2) sentence 3 AktG);
- The requirement to apply for the opening of insolvency proceedings (section 15a InsO).

5.2.1 Duty to notify the general meeting of a loss amounting to half of the share capital (section 92(1) AktG)

A loss amounts to half of the share capital if the company's assets equal half or less of the nominal capital.[169] Thus, the loss has to be compared to the total outstanding equity.[170] The annual deficit cannot be the reference point, as proposed by some,[171] as profits and capital reserves would not be considered. Therefore, not only one-time, but also gradual losses lead to the obligation to convene a

[167] See above: 4.1.1.3.
[168] *Goette*, in: FS Kreft, Recklinghausen 2004, 53, 58–59.
[169] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 92 para 2; *Kropff*, ZIP 2009, 1137, 1144–1145; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 92 para 9.
[170] Judgment of *BGH* from 09.10.1958, II ZR 348/56, WM 1958, 1416, 1417; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 92 para 2.
[171] *Habersack*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 92 paras 13 seq.

general meeting.[172] The applicable valuation rules are the same as those for the current annual balance sheet.[173] The realization and imparity principles and the reporting date principle continue to apply.[174]

The duty arises not only when the annual accounts are prepared. The director is required to monitor the financial situation of the company and draw up an interim balance sheet if necessary.[175]

5.2.2 Prohibition to make payments to creditors (section 92(2) sentence 1 AktG)

The prohibition begins according to the Federal Court of Justice with the existence of a statutory ground to start the insolvency procedure (*Insolvenzreife*).[176] Thus, the duty begins before, and not with,[177] the requirement to apply for the opening of insolvency proceedings according to section 15a InsO.

5.2.3 Prohibition to make payments to shareholders (section 92(2) sentence 3 AktG)

Payments to shareholders are only prohibited if they cause the company to fail paying its debts. What provides such a link is not clear. Legislative history suggests that the payment must have led to the company's failure to pay "without adding any further causal step".[178] It is not necessary that the default occurs at the moment of payment, but it must be clear that the company will not be able to meet its liability in the normal course of events.[179] There are several possibilities to interpret this requirement: first, it may be argued that the company's failure to pay must be a most likely result according to the solvency prognosis of an objective observer;[180] secondly, some commentators require a probability bordering on certainty;[181] thirdly, others hold that the payment must have substantially contributed to, or accelerated, the company's failure to pay its debts.[182]

[172] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 92 para 7; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 92 para 2; *Spindler*, in: Münchener Kommentar Aktiengesetz, 3rd edition, Munich 2008, § 92 para 9.

[173] *Habersack*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 92 para 18; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 92 para 3.

[174] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 92 para 8.

[175] *Habersack*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 92 para 17; *Mertens/Cahn*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 92 para 13.

[176] Judgment of *BGH* from 16.03.2009, II ZR 280/07, NZG 2009, 550; not deciding on this matter: Judgment of *BGH* from 29.11.1999, II ZR 273/98, BGHZ 143, 184, 188–189; concurring: *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 92 para 27; *Goette*, FS Kreft, Recklinghausen 2004, 53, 58–59; *Haas,* NZG 2004, 737, 739–740; *Habersack*, in: Großkommentar, 4th edition, Berlin 1999 seq., § 92 para 93; *Reuter*, BB 2003, 1797, 1803.

[177] For this starting point: *Liebs*, in: FS Rittner, Munich 1991, 369, 372 seq.; *Mertens/Cahn*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 92 para 27.

[178] Begründung, RegE MoMiG BT-Drucks 16/6140, 46 for § 64 Satz 3 GmbHG: "*ohne Hinzutreten weiterer Kausalbeiträge*".

[179] Begründung, RegE MoMiG BT-Drucks 16/6140, 47 for § 64 Satz 3 GmbHG: "*dass die Gesellschaft unter normalem Verlauf der Dinge ihre Verbindlichkeiten nicht mehr wird erfüllen können*".

[180] *Gehrlein*, Der Konzern 2007, 771, 795; *Greulich/Bunnemann*, NZI 2006, 681, 685; *Kleindiek*, in: Lutter/Hommelhoff/GmbHG, 17th edition, Cologne 2009, § 64 para 29; *Knof,* DStR 2007, 1536, 1540 & 1580, 1581; *Niesert/Hohler*, NZI 2009, 345, 350; *Wicke*, GmbHG § 64 Rn 29.

[181] *Greulich/Rau*, NZG 2008, 284, 288; *Greulich/Bunnemann*, NZG 2006, 681, 685; *Knapp*, DStR 2008, 2371, 2373; *Mertens/Cahn*, in: Kölner Kommentar, 3rd edition, Cologne 2010, § 92 para 52; *Schall*, Kapitalgesellschaftsrechtlicher Gläubigerschutz, Munich 2009, 201.

[182] *Haas*, in: Baumbach/Hueck, GmbHG, 19th edition, Munich 2010, § 64 para 105.

5.2.4 Requirement to apply for the opening of insolvency proceedings (section 15a InsO)

Section 15a InsO provides that the directors shall file a request for the opening of insolvency

proceedings without culpable delay, and at the latest within three weeks, after a company becomes illiquid or overindebted. According to section 17(2) sentence 1 InsO, a company is illiquid if it is unable to meet its obligations as they fall due. Pursuant to sentence 2 of the provision, this is assumed to be the case if the company has suspended its payments.[183]

The term "overindebtedness" is defined in section 19(2) InsO. This provision was amended in 2008 as a reaction to the financial crisis. The new version will only be in force for a limited period of time and is intended to give companies in financial difficulties more flexibility before insolvency proceedings have to be opened.

The definitions are as follows:

- From 31.12.2010-31.12.2013: according to the modified two-part concept of overindebtedness (*modifiziert zweigliedriger Überschuldungsbegriff*), the company is overindebted if its assets do not cover its existing obligations, unless the company's continued existence is highly likely, considering the circumstances;
- From 01.01.2014: the traditional definition applies, according to which the company is overindebted if its assets do not cover the existing liabilities.[184]

[183] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 92 paras 51–52.
[184] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 92 para 56.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue

6.1.1 The company as plaintiff

Generally, the supervisory board has authority to enforce claims of the company against members of the management board (section 112 AktG). It is the task of the supervisory board to assess and monitor potential claims and decide whether to instigate legal proceedings. The decision whether to enforce a claim in court is not a business decision; accordingly, the protections of the German business judgment rule do not apply. This was clarified by the Federal Court of Justice in ARAG/Garmenbeck.[185] However, the supervisory board is accorded some degree of discretion in balancing the risks associated with the litigation and the potentially harmful consequences for the company (in the form of reputational damage, disruption of management activities, and the disturbance of the work climate) on the one hand, and the financial advantages of enforcing the claim on the other hand.[186]

Section 147 AktG enables the shareholders to require the enforcement of claims against the directors by resolution adopted with simple majority. The claims will be enforced in the name of the company, and the usual provisions regarding the authority to represent the company apply. This means that the supervisory board enforces claims against members of the management board, and the management board enforces claims against members of the supervisory board. The competent corporate organ has to file the claim within six months after the decision of the general meeting (section 147(1) sentence 2 AktG). Noncompliance with this requirement leads to liability according to sections 93, 116 AktG.

Alternatively, the general meeting may appoint a special representative for purposes of asserting the claim, or a minority holding at least 10 percent of the share capital or a proportionate amount of EUR 1 million may apply to the court to appoint the special representative (section 147(2) AktG).[187]

6.1.2 The shareholders as plaintiffs

According to section 148(1) AktG, shareholders who hold at least one hundredth of the share capital in aggregate or a proportionate amount of EUR 100,000, may apply for the admission of an action to enforce the company's claims in their own name against board members.[188] Relief is sought on behalf of the company. This provision, therefore, embodies the German derivative action mechanism. It was reformed in 2005 to introduce a claim admission procedure that seeks to balance the need to protect minority shareholders against the refusal of conflicted organs to enforce the company's claims on the

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[185] Judgment of *BGH* from 21.04.1997, II ZR 175/95, BGHZ 135, 244, 254 seq.
[186] Ibid.
[187] *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 147 para 8.
[188] *Paschos/Neumann*, DB 2005, 1779; *Schütz*, NZG 2005, 5, 6–7; *K. Schmidt*, NZG 2005, 796.

one hand, and the risk of strike suits to extract a settlement value from the company on the other hand.

According to section 148(1) AktG, the court shall grant permission to pursue the claim if the following four conditions are satisfied:

- The shareholders show that they acquired the shares before they knew, or should have know, of the alleged breach of duty;
- The shareholders prove that they requested the company to bring a claim, but the company failed to do so within a reasonable time;
- Facts exist that justify the assumption that the company suffered a loss due to dishonesty or gross violation of legal provisions or the articles of association; and
- Pursuing the claim is, on balance, not outweighed in the interest of the company.

Section 148(6) AktG contains cost rules. The section provides that the claimant has to bear the costs of the admission procedure if the application is dismissed, unless the dismissal is due to facts relating to the interest of the company that the company could have disclosed prior to the application, but did not disclose. In that case, the company shall reimburse the claimant for the costs. Similarly, if the application is successful, but the claim is dismissed in whole or in part, the company shall reimburse the claimants, unless they secured the admission through pleadings that were intentionally or grossly negligently incorrect. In spite of these reforms, the practical relevance of the derivative action has, so far, remained low.[189]

6.1.3 The creditors as plaintiffs

Creditors are able to enforce the company's claims for damages pursuant to section 93(5) AktG. As mentioned above, the provision requires that the creditors are unable to obtain satisfaction from the company. In addition, the company's claim for damages must be based on gross negligence. Because the company will generally be insolvent if the creditors are unable to obtain satisfaction, which has the consequence that the liquidator shall exercise the creditors' rights (section 93(5) sentence 4 AktG), the mechanism is not often used.[190]

6.2 Criminal and administrative sanctions

6.2.1 Criminal liability

Directors may be criminally liable for business-related offences committed by themselves, e.g. breach of trust (*Untreue*, section 266 Criminal Code (StGB)),[191] withholding and embezzlement of wages (*Vorenthalten und Veruntreuen von Arbeitsentgelt*, section 266a StGB),[192] or for offences committed

[189] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 147 para 33.
[190] *Fleischer*, in: Spindler/Stilz, 2nd edition, Munich 2010, § 93 para 293.
[191] *Spindler*, in: Handbuch des Vorstandsrechts, Munich 2006, § 15 paras 13 seq.
[192] *Spindler*, in: Handbuch des Vorstandsrechts, Munich 2006, § 15 paras 57 seq.

by other corporate actors, e.g. violation of criminal organization offences,[193] breach of the duty of supervision according to section 130 Act on Regulatory Offences (OWiG),[194] and crimes or misdemeanours in corporate groups.[195] Section 15a(4), (5) InsO provides for criminal liability for the failure to apply for the opening of insolvency proceedings.

As far as the position of *de facto* directors is concerned, the German Federal Court of Justice applies criminal laws to *de facto* directors who manage a company with the consent of the company.[196] This includes the offence of failing to apply for the opening of insolvency proceedings within the required time limit.[197] Shadow directors, on the other hand, are not held liable in Germany.

6.2.2 Disqualification of directors

The supervisory board may disqualify the director for a specified period of time. This mechanism is not expressly regulated in the Stock Corporation Act, but some courts acknowledge the power of the supervisory board to adopt a disqualification resolution, provided that the board could have legally revoked the appointment of the director.[198] Therefore, the requirements of section 84(3) AktG must be satisfied. In particular, disqualification requires an important reason.

[193] *Spindler*, in: Handbuch des Vorstandsrechts, Munich 2006, § 15 paras 68 seq.
[194] *Spindler*, in: Handbuch des Vorstandsrechts, Munich 2006, § 15 paras 94 seq.
[195] *Spindler*, in: Handbuch des Vorstandsrechts, Munich 2006, § 15 paras 124 seq.
[196] Judgment of *BGH* from 24.06.1952, 1 StR 153/52, BGHSt 3, 32, 37 seq.; Judgment of *BGH* from 05.10.1954, 2 StR 447/53, BGHSt 6, 314, 315–316; Judgment of *BGH* from 28.06.1966, 1 StR 414/65, BGHSt 21, 101: „Mitglied des Vorstands einer Aktiengesellschaft kann auch sein, wer, ohne förmlich dazu bestellt und im Handelsregister eingetragen zu sein, im Einverständnis des Aufsichtsrats die Stellung eines Vorstandsmitglieds tatsächlich einnimmt".
[197] Judgment of *BGH* from 22.09.1982, 3 StR 287/82, BGHSt 31, 118.
[198] Judgment of *KG* from 08.07.1983, 14 U 259/83, AG 1984, 24, 25; Judgment of *OLG München* from 17.09.1985, 7 W 1933/85, AG 1986, 234, 235; Judgment of *LG München I* from 27.06.1985, 5 HKO 9397/85, AG 1986, 142; *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 84 para 35; *Meyer-Landrut*, in: Großkommentar, 3rd edition, Berlin 1971 seq., § 84 para 28.

7 CONFLICT OF LAWS

7.1 Classification under Germany's private international law

The classification of the different grounds for liability of directors for purposes of private international law generally follows their classification according to substantive law (contract, tort, company law or insolvency law).

7.1.1 Duties of care and loyalty & the general principles of negligence

The duties of care and loyalty are generally governed by private international company law.[199] The general principles of negligence, misrepresentation and deceit, which are regulated in the Civil Code (BGB), are classified as tort law.[200]

7.1.2 Duties in the vicinity of insolvency

It is more difficult to identify the correct conflict of laws rule for the four duties in the vicinity of insolvency, the duty to call a general meeting in case of a loss amounting to half of the share capital,[201] the prohibition to make payments to creditors,[202] the prohibition to make payments to shareholders,[203] and the duty to apply for the opening of insolvency proceedings.[204]

These duties are laid down in the Stock Corporation Act and the Insolvency Act, respectively. Therefore, it could be argued that private international law should follow this classification. However, the courts and most commentators hold that the statutory location of the provision is irrelevant. Rather, the question is whether the insolvency or financial distress of the company is merely one of several elements of the provision, which imposes specified restrictions on the conduct of directors, or whether the provision directly serves to realise the goals of the insolvency procedure (*insolvenzpolitische Ziele*). In the former case, the provision is to be classified as company law, in the latter as insolvency law.[205]

According to these principles, the prohibitions to make payments to creditors or shareholders in the vicinity of insolvency, while regulated in the Stock Corporation Act, are classified as insolvency law. They aim to preserve the company's assets for the benefit of the creditors. Consequently, they pursue

[199] *Müller*, in: Spindler/Stilz, 2nd edition, Munich 2010, Internationales Gesellschaftsrecht, para 36.
[200] *Forsthoff/Schulz*, in: Hirte/Bücker, Grenzüberschreitende Gesellschaften, Cologne 2005, § 16 para 110; *Müller*, in: Spindler/Stilz, 2nd edition, Munich 2010, Internationales Gesellschaftsrecht, para 36.
[201] Section 92(1) AktG.
[202] Section 92(2) sentence 1 AktG.
[203] Section 92(2) sentence 3 AktG.
[204] Section 15a InsO.
[205] Judgment of *BGH* from 11.07.1985, IX ZR 178/84, NJW 1985, 2897; *Haas*, NZI 2002, 457, 466; *Hanisch*, ZIP 1983, 1289, 1296–1297; *v. Hoffmann*, in: Staudinger, 13th edition 1998 seq., Art. 38 EGBGB para 109; *Kindler*, in: Münchener Kommentar BGB, 5th edition, Munich 2010, Internationales Gesellschaftsrecht, paras 253 seq.; *Karsten Schmidt*, in: FS Großfeld, Tübingen 1998, 1031, 1040–1041; *Trunk*, Internationales Insolvenzrecht, Tübingen 1998, 5 seq.

a clear insolvency aim. This interpretation is in line with the intention of the legislature as expressed in the legislative documents.[206]

The duty to convene a general meeting and notify the general meeting of a loss amounting to half of the share capital should, according to some commentators, be classified similar to other accounting duties, i.e. as public law.[207] However, while the provision pursues partly public goals, it is grounded in company law and specifically designed to address the conflicts that arise in stock corporations. In addition, considering that the duty does not only become relevant in the vicinity of insolvency, but also in cases where insolvency is unlikely, it should be classified as company law.[208]

The classification of the requirement to apply for the opening of insolvency proceedings is controversial. Some commentators argue that it should follow principles of international company law,[209] while others classify it as insolvency law.[210] Given that the duty's aim is to prevent a delayed opening of insolvency proceedings, it pursues insolvency goals and should be qualified as insolvency law.[211]

7.2 Relevant rules of private international law

7.2.1 Company law

German international company law is not codified. Initially, Germany followed the real seat theory to determine the law applicable to companies.[212] However, since the judgments of the European Court of Justice in *Überseering* and *Inspire Act* the German courts have moved to the incorporation theory in order to ensure conformity with Articles 49, 54 TFEU.[213]

7.2.2 Tort law

In tort law, Regulation (EC) No 864/2007 (Rome II) applies. Thus, the law of the country in which the damage occurs is applicable unless there is a closer connection with another country (Art. 4(1), (3) Regulation (EC) No 864/2007).

[206] Begr RegE MoMiG, BT-Drucks 16/6140, 47; Judgment of *KG* from 24.09.2009, 8 U 250/08, NZG 2010, 71, 72–73; *Eidenmüller*, RabelsZ 70 (2006), 474, 498; *Hirte*, in: Hirte/Bücker, Grenzüberschreitende Gesellschaften, Cologne 2005, § 11 para 75; *Vallender*, ZGR 2006, 425, 455.
[207] *Kindler*, in: Münchener Kommentar BGB, 5th edition, Munich 2010, Internationales Gesellschaftsrecht, paras 532 seq.
[208] *Müller*, in: Spindler/Stilz, 2nd edition, Munich 2010, Internationales Gesellschaftsrecht, para 42.
[209] *Bayer*, BB 2003, 2357, 2365; *von Hase*, BB 2006, 2141 seq.; *Mock/Schildt*, ZInsO 2003, 396, 400; *Mock/Schildt*, in Hirte/Bücker § 17 paras 66 seq.; *Ringe/Willemer*, EuZW 2006, 621 seq.; *Spindler/Berner*, RIW 2004, 7, 11 seq.; *Teichmann*, Binnenmarktkonformes Gesellschaftsrecht, Berlin 2006, 521 seq.
[210] Judgment of *LG Kiel* from 20.04.2006, 10 S 44/05, NZG 2006, 672; *Eidenmüller*, RabelsZ 70 (2006), 474, 497–498; *Kindler*, in: Münchener Kommentar BGB, 5th edition, Munich 2010, Internationales Gesellschaftsrecht, para 625; *Müller*, in: Spindler/Stilz, 2nd edition, Munich 2010, Internationales Gesellschaftsrecht, para 36; *H. F. Müller*, NZG 2003, 414, 417; *Vallender*, ZGR 2006, 425, 455.
[211] Arguing in this direction: *Müller*, in: Spindler/Stilz, 2nd edition, Munich 2010, Internationales Gesellschaftsrecht, para 36.
[212] Judgment of *BGH* from 30.01.1970, V ZR 139/68, BGHZ 53, 181, 183; Judgment of *BGH* from V ZR 10/85, 21.03.1986, BGHZ 97, 269, 271
[213] Judgment of *BGH* from 13.03.2003, VII ZR 370/98, BGHZ 154, 185, 189; Judgment of *BGH* from 19.09.2005, II ZR 372/03, BGHZ 164, 148. For a more detailed analysis see: *Hüffer*, in: Hüffer, 9th edition, Munich 2010, § 1 paras 33–37; *Randelzhofer/Forsthoff*, in: Grabitz/Hilf, Das Recht der Europäischen Union, 40th edition, Munich 2009, Art. 48 paras 75–77.

7.2.3 Insolvency law

International insolvency law is regulated by Regulation (EC) No 1346/2000. According to Art. 4(1) of the Regulation the law of the state applies where the insolvency proceedings are opened

DIRECTORS' DUTIES AND LIABILITY IN GREECE

Initial author: Nikoletta-Izampella Tsirmpa

CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in Greece

Greek law is part of the civil law legal family. In this context, legislation is the most important source of law in contrast to common law systems, and only enacted laws either in the form of codes or other statutes along with customary and international law are binding sources of law (Civil Code, Art. 1). Custom is only used in conformity with enacted law *intra* or *praeter legem* and never *contra legem*. Furthermore, in accordance with art. 28(1) of the Greek Constitution, the generally accepted rules of international law as well as ratified international treaties are construed as part of the domestic law. Thus, judicial decisions and the writings of legal scholars do not constitute binding sources of law, although they play a complementary role and can have an important strong influence on both the legislator when enacting the law and on the courts in relation to how they interpret it. In other words, the role of the courts is to interpret law and not to make law. The Courts' position within the Greek legal system is best seen in cases where general concepts or clauses in a Statute are applied to a particular case. Greek courts do not possess a law-making capacity hence they are not formally bound by judicial precedent, nevertheless they only usually follow the established practice, especially when it has been amply demonstrated in a number of decisions. In line with this, established practice in decisions of the higher courts and especially those of the *"Areios Pagos"* (the Supreme Civil and Criminal Court) play an important role in the decision-making process of the lower courts.

With particular reference to Greek corporate law, Codified Law 2190/1920 (issued on 5/30 June 1920) on companies limited by shares (*sociétés anonymes*) as amended by various statutes is the principal statute governing issues relevant to public companies. In addition, Law 3016/2002 is applicable to corporate governance issues in the case of listed public companies.[1]

Numerous provisions for public companies are placed in several other statutes, including L. 3190/1955 on limited liability companies, where certain provisions apply directly or by analogy to public companies, the Civil Code (general rules in relation to legal entities and partnerships, securities etc.), the Presidential Decree 226/1992 and Law 3693/2008 governing the establishment, organisation and function of the Body of Certified Public Accountants, Emergency Law 148/67, Law 2065/92 and Law 3604/2007. Moreover, for public companies listed in the Athens Stock Exchange, Law 3606/2007 (which amended L. 3632/1928, Stock Exchange Regulation) is also applicable.

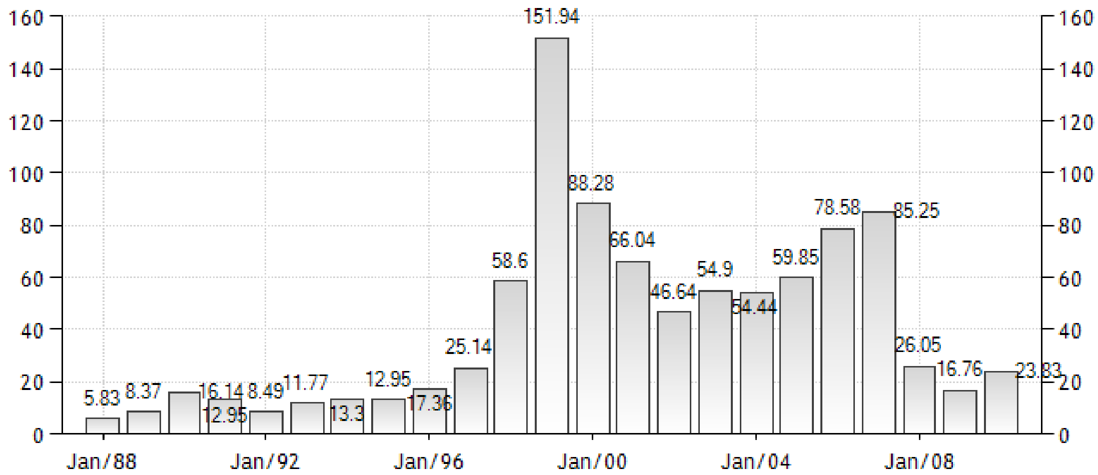
For certain types of institutions, such as banks and insurance companies, additional special rules apply. More specifically, there is a special legal regime governing banking institutions (the establishment and operation of credit/financial institutions is mainly governed by Law 3601/2007, as amended by art. 10 of L. 4051/2012), insurance public companies (Law Decree 400/70 as amended by L. 3487/2006 and L. 3746/2009), leasing companies (L. 1665/1986), factoring companies (L. 1905/90) and asset management companies, as well as mutual fund management companies (L. 3283/2004 on "Asset Management Companies and Mutual Fund Management Companies"). Finally,

[1] It is worth noting that this particular Statute was issued three years after the great scandals in the Greek stock market and the Greek Legislator tried to tackle certain problems that arose.

for public companies established by the Greek State or where the Greek State or any legal entity of public law (*ΝΠΔΔ*) holds the majority of shares, Law 3371/2005 is additionally applicable[2].

It is worth noting that the law governing public companies consists for the most part of *ius cogens* rules. The Greek legislator's stance on this particular issue reflects its intention to enhance legal certainty for third parties who are in a contractual relationship with the company and protect non-sophisticated shareholders.[3]

Corporate landscape in Greece



Market capitalisation of listed companies in Greece – US dollar[4]

In essence, the issues pertaining to the efficiency of the corporate governance frameworks originate from the distinction between ownership and control of the corporation. The rights and responsibilities of all agents are examined with the view of securing the best possible outcome in the performance of the corporation and the subsequent rise in its market value. In this view, the accomplishment of good long-term corporate performance and sustainability is of primary importance. There are considerable and important particularities in the structure and operation of Greek companies, given the way the country's productive and financial structure was developed. With respect to the corporate ownership structure, existing studies show high concentration levels in production and decision-making processes and low dispersion in the market for corporate control[5].

Under Greek law corporate entities may be divided into two categories: personal companies and capital companies. The former category includes unlimited (or general) partnerships which are governed by Articles 249-270 of Law 4072/2012 and Articles 741-783 of the Civil Code, limited (Articles 271-284 of Law 4072/2012) or civil partnerships (Article 784 of the Civil Code), while the latter consists of limited liability companies (Law 3190/1955), private companies (articles 43-120 of Law 4072/2012) and public corporations («*sociétés anonymes*»). Other corporate entities include

[2] Pursuant Law Decree 4015/1959 special provisions apply in this case with reference to the number and the appointment of members of the Board of directors (Art. 1(a)).
[3] See, Alexandridou, E., *Corporate law («Δίκαιο εμπορικών εταιριών»), vol II*, 2nd ed., Sakkoulas ed., Thessaloniki, 2000, p. 3.
[4] http://www.tradingeconomics.com/greece/market-capitalization-of-listed-companies-percent-of-gdp-wb-data.html
[5] See, *Principles on Corporate Governance in Greece: Recommendations for its competitive transformation,* Capital Markets Commission, Athens, 1999 available at http://www.ecgi.org/codes/documents/greece_engl.pdf; see also, the Country Governance Study for Greece by Standard and Poor's, February 9 2005 available at http://www.iraj.gr/iraj/greece_country_governance_study.pdf.

branches of foreign corporations, offshore branches of foreign corporations under Law 89/67 and L. 3427/2005 as well as joint ventures.

Under Law 2190/1920, a public company is a share capital company in which the liability of the shareholders is limited to the amount of their capital contribution, evidenced by the shares they hold. The minimum share capital for a public company is 60,000 Euros (art.8, par.2, L.2190/20 as this was replaced by art.11 par.1 of L.2579/98 and 2842/2000), an amount that must be fully subscribed at formation and paid in, in cash or in kind, within two months after incorporation. However, for specific types of companies the law requires a significantly higher initial share capital (that is the case for listed companies, credit and insurance institutions etc.). In the case of payment in kind, the value of the assets contributed will be evaluated by a committee nominated by the Ministry of Commerce or pursuant to art. 9 para 4 by two auditors or two certified public accountants who will be paid by the company if it stated in the company's articles of association or if it is decided by the board of directors. If the capital of the company under incorporation exceeds the minimum requirement, it is possible that 75 per cent of the amount excess may be paid within five years and not at the formation.

1.3 The Board of a Greek Company

1.3.1 Role

Under Greek law public limited companies must have three (corporate) organs: the board of directors ("BoD"), which is responsible for the management and the representation of the company, the general meeting, which is entrusted with the responsibility to reflect in its decisions the company's "business will" and the auditors, who are deemed as the organ accountable for monitoring the actions of the board of directors[6]. The company's articles of association must include certain provisions regarding the company's formation, operation and the responsibilities in relation to each and every corporate organ, if it is to be validly registered and, in some cases, obtain the necessary approval by the relevant administrative authorities. Generally, the rules setting out the responsibilities of each corporate organ are deemed to be mandatory law. It is possible, however, that the company's articles of association may include provisions creating secondary or substitute corporate organs to which certain or even all BoD's powers may be conveyed[7].

More specifically, the BoD is a collective corporate organ in which the management of the company is vested. In other words, the board is responsible for planning and executing business decisions (including actions relevant to the company's internal management), as well as for representing the company (external relationships)[8]. When it is acting within the scope of its powers, the board's actions are binding upon the company (art. 70 and 71 of the Greek Civil Code). However, as aforementioned, the board may convey to one or more of its members and/or to the executive officer of the corporation part of its powers (or even all of them). The board has the responsibility to deal with the company's affairs exclusively in accordance with the legal entity's interests whilst abiding by all relevant provisions. In addition, the BoD has to set the company's long-term goals, to make all strategic

[6] See, Antonopoulos V., *The law of public limited company and of Ltd.,* 4th ed., Thessaloniki, 2012, Sakkoulas, p.409.
[7] Ibid.
[8] See, Art. 18 para 1-3, 22 para 1; Supreme Court no 1215/2000, EEmpD 2002, p. 369; Supreme Court no 1979/2008 ElDni 2009, p. 492; Athens One-member Court no 5079/2002 EEmpD 2002, p. 572.
With reference to the Board's representation power, it is worth noting that under art. 126 para 1 (d) of the Civil Procedure Code, the Board is the responsible corporate organ to express the company's intention especially in the case of legal instruments. The general principles of representation and assignment are not directly applicable, see art. 68 para 2 of the Greek Civil Code.

decisions, and to provide input in the achievement of the company's strategic goals (for example, provide access to valuable resources and information).

The number of the BoD's members may be either stated upfront in the company's articles of association or it can be decided by the general meeting, but in any event it cannot be less than three members (art. 18 para 2, sub. 1-2). It is worth noting that members of the BoD are not registered with the Commercial Registry/Trade Registry for natural persons (they do not acquire the so-called "commercial status", «εμπορική ιδιότητα» like parties to personal companies). Moreover, a legal person can also become member of the BoD, if so provided by the company's articles of association, as long as the latter appoints a natural person/representative to participate in the BoD's meetings (art. 18 para 2, sub. 3-4). It should be noted that since the BoD's management and representation powers concern the company as a legal entity and not the shareholders *per* se, members of the BoD do not have as a prerequisite to be shareholders in the company (in contrast to personal companies, such as partnerships).

BoD's members are elected by the general meeting (art. 34 para 1, sub. B) for a limited period of time which may be either stated in the company's articles of association [9] or be determined by the general meeting. The terms do not necessarily have to be the same for all members of the BoD (i.e. each director may hold office for a different term). In addition, members of the BoD can always be re-elected in their positions[10] (art. 19 para 2 of L. 2190/1920) [11]. However, they may not participate in the BoD for a period more than six years as stipulated in art. 19 para 1, sub. 1 of L. 2190/1920[12] or in any event for the period stated in the company's articles of association, which may be shorter than the statutory provision (i.e. six years[13]). Furthermore, a member of the BoD automatically ceases to hold office in the event of its resignation, death or inability, however for the protection of *bona fide* third parties the point in time when this event is considered to be effective against them is according to art. 7a para 1 (c) and 7b when it is published in the SA and LtD series. It should be mentioned that this publicity rule applies to all cases in relation to the end of a member's term, apart from the case when the period for which the member of the BoD was elected to hold office ends and only if the duration of the member's office is already published (for example, it may be stated in company's articles of association).

In any event, pursuant to art. 19 para 2 of L.2190/1920 members of the BoD are "freely revocable". This means that the general meeting (with a common quorum/ majority) can revoke anytime and without "a significant reason" the power conferred upon a certain member of the BoD or the corporate organ as a whole.[14] Similarly, this principle also applies to directors who are not shareholders. This is a *jus cogens* provision, which means that it cannot be diluted by a special provision in the company's articles of association stating the contrary. In this context, a member of the BoD either elected by the general meeting, or appointed under the company's articles of association, or by the courts in the event of absence of management with reference to the company's business affairs or even by the BoD[15] may be revoked for any reason (and not simply for breach of duty) by the general meeting (the

[9] See, Passias, I., *The law of public company («Το δίκαιο της ανωνύμου εταιρίας»),* Athens, 1969, p. 472.
[10] See, contra Passias, op.cit., p. 475.
[11] No clause prohibiting the re-election of BoD's members in the company's articles of association is allowed, see Athens Court of First Instance 177/2002, NoB 2003, p. 1654.
[12] See, Anastasiadis I./Rokas K., *Greek Commercial Law*, vol. I, 5th ed., Athens, 1949, p. 364. See also, Supreme Court 5/2004 ElDni 2004, p. 388.
[13] See, Supreme Court 5/2004, ElDni 2004, p. 388.
[14] See, Athens Court of Appeals 1486/2011,DEE 2011, p. 682.
[15] The BoD has the right to appoint a new member in the event of another's resignation, death, inability or impeachment.

whole BoD may be revoked, too) if it loses the latter's trust (shareholders participating in the general meeting are not obliged to justify their decision whatsoever).[16]

Finally, in the event of the expiration of term of the BoD as a whole (after six years, or the period set out in the company's articles of association) under the new provision of art. 19 para 1 (2) (as inserted by art. 26 para 2 of L. 3604/2007), the BoD continues to hold its office even after the expiration of its term until the next general meeting of shareholders (max. six months after the end of the financial/business year).

With reference to the location where BoD's meetings may validly be held, Article 20 para 1 of L. 2190/1920 states that the BoD must meet at the registered office of the company. This is a statutory mandate, however it is possible that apart from the location stipulated in this statutory mandate or the Articles of Association it is possible for a meeting to take place wherever if it is considered to be required due to the company's needs. In this context, it is possible for the members of the BoD to meet in a location (domestic or international) other than the company's registered office as long as all of its members are present and no one is objecting (Article 20 para 3). There is also the possibility of a teleconference (Article 20 para 3a).

As a general rule, absolute majority is required for BoD's decisions of the members being present or represented at the meeting. Each member of the BoD may represent one more member as their agent, if it has obtained their prior written authorisation. However, the minimum quorum permissible by the law for holding a meeting is not less than three members present at the meeting. Finally, the minutes kept during a BoD's meeting are used as evidence of the organ's decisions.

One of the board's main responsibilities is to ensure the establishment of efficient management rules. Under this scope, the BoD is accountable to the general meeting in relation to its activities and its general performance. On the other hand, the general meeting has a duty to appoint members of the BoD and to approve the company's general strategy.

Pursuant to Article 7 para 3 of L. 3016/2002 internal auditors who are fully and exclusively occupied in the company are appointed by the board of directors.

According to Article 2 of Law 3016/2002 members of the BoD have a duty to *"constantly pursue the long-term enhancement of the company's financial position and the protection of its general corporate interests."* In this context (and in conjunction with art. 22A of Law 2190/1920), there is a clear prohibition on directors to participate in activities that could potentially result in a "conflict of interests" situation, i.e. when a director's personal interests are in conflict with the interests of the company as a whole. Given the fact that there is no clear definition of the notion "general corporate interest" it is rather difficult to determine *a priori* all those situations which could potentially result in a conflict between the personal interests of a director and those of the company. There are however several theories proclaiming *inter alia* that the notion of a company's "general interests" is limited to the shareholders' interests; it involves the company's interests as an economic entity/unit; it is identical to the corporate objects stipulated in its articles of association; it includes all third parties' (stakeholders') interests (employees, clients); it is considered as a variable-geometry notion (it is identified *ad hoc* by the courts). The dominant position among these theories seems to be that the shareholders' interests

[16] The members of the BoD who are specially appointed by shareholders under Art. 18 para 3 of L. 2190/1920 cannot be disqualified by the General Meeting but from the shareholders or the shareholder who appointed them in the first place after obtaining the Court's permission.

have generally to prevail, and that other interests (those of employees, customers, creditors etc.) have to be protected by the relevant legislation (on the protection of employees, consumers etc.).

1.3.2 Structure

Generally, the internal corporate structure of a public company is based on the fundamental principle of a *separation of powers*[17]. Corporate organs have special powers emanating either straight from statutory law or from the company's articles of association. More specifically, whilst the general meeting is entitled to exercise control over the behaviour of managers indirectly ("monitoring power") by virtue of their discretion over the approval of the annual balance sheet of the company, members of the board when acting individually have no power to exercise any control over the BoD's decisions.[18] The BoD, however, may grant to some of its members the right to monitor or supervise its acts with a special provision in the company's articles of association or with special authorisation.[19]

Pursuant to Law 2190/1920, the Greek legislator chose to apply the one-tier model structure. In the case of *listed companies* the board consists of executive and non-executive members. The latter's number should not be less than 1/3 of the total number of BoD's members. The classification of executive and non-executive positions is generally made by the BoD, while two independent members, chosen among the non-executive members, are appointed by the general assembly. The independent non-executive members of the board of directors until the end of their office are not allowed to hold more than 0.5% of the company's shares and they are not allowed to have any "dependence relation" with the company or with any of the company's affiliates (for instance with the company's subsidiaries).

In the context of the one-tier system chosen by the Greek legislator, "employee participation" is not provided for. It should be mentioned, however, that within every public company there are the so-called "work councils" (a legal implant from the English jurisprudence), which under Law 1767/88 (which ratified the Convention No 135 of the International Labour Conference) aims at the *"protection of the employees' representatives within the company"* by including a minimum level of aid/assistance that employers should provide to their employees.[20] However, these councils have a rather complementary, advisory role to the company; in the wording of art. 12 para 1 of Law 1767/88 "the function of these councils is participatory and advisory aiming at the amelioration of the working conditions as part of the company's further development." Less direct and active participation of employees in the company's management and in the decision-making process especially in relation to the most significant issues for the company is basically the result of many historical reasons relating primarily to the country's economic structure. Thus, in contrast to many other European jurisdictions, like Germany for example, the representatives of workers do not participate in either the general meeting or the board of directors, unless they are shareholders in the company (in which case they participate as shareholders and not as representatives of the company's workforce).

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[17] See, Mouzoula S., "The powers of organs in Public Companies – Thoughts on the implementation of the 5th Directive", ArchN 1986, p. 562.

[18] See contra, Athens Multi-member Court of First Instance 1263/1972, EempD 1973, p. 360/ NoV 1973, p. 669, where the Court recognized the possibility of control over the management of the company by individual Members of the Board under Law 2190/1920.

[19] See, Passias I., *The law of public company,* Athens, 1969, p. 451; For a thorough analysis on the distinction between the executive and non-executive as well independent members of the Board see Perakis E., "Briefing of the Members of the Board of Directors", EEmpD 1991, p. 1 et seq.; Mouzoula, *Governance of public companies*, supra, 1475-1476. According to art. 36 of Law 2190/1920 the management of a company is monitored by auditors as well.

[20] Under Recommendation no 145 there is a list of assistance tools that could be provided to the representatives of these councils. Nevertheless, this particular Recommendation has not been ratified by the Greek Parliament, hence it does not apply in the relevant cases.

2 The concept of 'company director' in Greece

2.1 De iure directors

2.1.1 Requirements to become a *de iure* director

Members of the board of directors in a public company (S.A.) may be natural or legal persons. In the case of natural persons a company director has the power to act in the name of the company; hence it must be a legally competent individual[21]. Any subsequent inability relating to the exercise of any of these powers results in an inability to act as a director of the company[22]. In addition, according to Article 37(4) of Law 2190/1920 a director cannot be an auditor within the company.

Under art. 18 of Law 2190/1920 it is permissible for a legal entity to be a member of the board of directors in another company. In such cases the legal entity has to appoint its representative, a natural person, to the BoD.[23] This representative is not deemed to be a "director" in the company where it is appointed. However, he/she has equal liability to that of the legal entity that appointed this representative as its agent under Article 71 of the Civil Code. On the other hand, the members of the BoD in the legal entity that appointed a representative to the BoD of another company do not directly assume liability for the tort committed by the agent as long as they do not encourage the tortious act[24].

2.1.2 Who can be *de iure* director

Certain occupations are incompatible with the director's position in a public company. In the event of a breach of this rule [25], both the director and its company may face liability.

More specifically, the director's position within a public company is incompatible with the position of:

- A member of the Greek Parliament (art. 57 of the Greek Constitution);
- Public prosecutors, judges, Court secretariats (art. 89 of the Greek Constitution and art. 41(2) of Law 1756/88);
- Civil servants without prior authorisation (art. 32(2) Law 2683/99. Nevertheless, art. 32(5) of Law 2683/99 allows the participation of civil servants as such to the management of public companies controlled by the State, the public law bodies and institutions, local government

[21] See Georgacopoulos L., *The law of companies,*vol. III, Athens, 1974, p. 27; *Manuscript on corporate law*, vol. I, The merchandisers, II, Afoi Sakkoula, Athens 1996, p. 280 in fine, Passias I., *The law of public company*, Athens 1969, p. 459, Rokas N., *Commercial companies*, 4th ed. [now 6th ed.], A. Sakkoulas, Athens-Komotini, 1996, p. 200; Levantis E., *Public Companies,* vol. I, art. 1-30, 9th ed., A. Sakkoulas, Athens-Komotini, 1994, p. 497; Markou I., *Decisions of the Board of Directors in a public company, Faults and consequences*, ed. Dikaio kai Oikonomia, Athens, 1996, p. 48 footnote 79.
[22] See, Passias, *supra*, p. 512; Georgacopoulos, *The law …*, supra, p. 32; Karavas, supra, p. 378.
[23] See, Opinion of the State Legal Council 21.12.1949, Arm 1950, p.210.
[24] See, ibid.
[25] See, Passias, surpa, p. 468; Karavas, supra, p. 324; Georgacopoulos, supra, p. 30-31.

organisations and public services, when there is a relevant special statutory provision applicable;

- Qualified lawyers. According to art. 63(2) of the Lawyers' Code it is incompatible with a lawyer's profession to hold the position of managing director or to represent a public company without obtaining prior consent by the relevant Bar Association (in which the lawyer is a member). There is no violation however, if a lawyer is the Chairman of the BoD or holds the position of a financial adviser in the company. It is worth noting that the Greek legal literature interprets this contradictory provision (since members of the board are also directors of the public company) broadly and adopting a more functional approach, since the Greek Legislator in art. 63(2) seems to aim at the non-appointment of lawyers to a company's representative position (as it is stated in art. 22(3) of Law 2190/1920)[26] (under the Greek law, a member of the BoD exercises both the company's management and represents the company).

Moreover, it is a highly disputed topic whether an insolvent person may be elected in the board of directors or what happens when an elected or appointed member of the BoD becomes insolvent.[27] In the latter case, it is accepted that its insolvency does not automatically signify the end of its office, since it continues being a legally competent individual, however it is possible that in this case the director may be disqualified by the general meeting.

2.2 *De facto* and shadow directors

Greek jurisprudence accepts the notion of "de facto directors" («*dirigeants de fait*»). More specifically, a *de facto* director is a person that either as a result of its position within the company (for instance controlling shareholders) or its relationship with the company (for example, major creditors, suppliers etc.) exercises significant influence over the board of directors, hence over the management of the company[28]. In this context, it is accepted that if the company suffers damages or becomes insolvent due to the actions of a *de facto* director in relation to the board's decisions (manipulating the BoD's actions), it is possible that the former may have criminal and civil liability[29].

As a practical matter, in order to characterise someone as a *de facto* director there are three prerequisites that need to be met:

1) The alleged "de facto director" has to take part in the company's management, having a *real* and *active* role in the company's decision-making (at least with reference to the significant decisions for the financial welfare of the company);

2) His appointment as director has not occurred or is *contra legem* (violating the appointment procedures as stipulated in L. 2190/1920); and

3) The company either encouraged the director's actions or knowingly permitted or tolerated them.[30]

[26] See, Levantis, supra, p. 497.
[27] In favour of such possibility, see Passias, supra, p. 459 in fine; Arguriadis A., in *Arm* 1977, p. 617; Athens One-member Court of First Instance decision no 18086/60, NoV 1961, p.260; Piraeus One-member Court of First Instance, decision no 93/70, Arch N. 1970, p. 897. Contra, Georgakopoulos, The law…, supra, p. 47, where the author notes that the insolvency of a director results in the automatic end of his/her capacity in the Board of directors. See also, Mazis P., "Representation of a public company by insolvent individuals", EEmpD, 1988, p. 173.
[28] See, Roka N., op.cit., p. 325.
[29] Ibid.
[30] See, Kokkinis, *Insolvency of public company and directors' liability against the company's creditors,* p. 349 et seq., and 363-366; see Marinos D. [att.], 2000, p. 864 et seq.

As the Greek law does not directly recognise the notion of a "shadow director", the notion of a "de facto" organ fills in a "liability hiatus" regarding the administrative corporate regime, especially in relation to cases where the appointment of one of the members of the BoD or of the BoD as a whole in a broader sense [31] is *ab initio* defective and cannot be cured"[32].

The actions of a *de facto* board of directors are binding on the company against third parties. This is an illustrative example of what it is known in legal theory as "apparent agent" or "apparent authority"; the legislator is protecting third *bona fide* parties when a certain assumption/trust is created by the company's counterparty acting in good faith and based on certain events. In other words, if a third party mistakenly believes that a de facto director has *actual* authority to act on behalf of the company, actions of that director will be binding for the company, provided that the third party's belief was reasonable.[33] In this context, the *de facto* director himself is also liable towards third *bona fide* parties[34].

Finally, the Insolvency Act (Law 3588/2007) includes specific provisions in relation to the liability of third persons who "exercised influence" on decisions made by the board of directors that caused the insolvency of the company. More specifically, under Article 98 para 2 of the Insolvency Code even third parties (*de facto* directors) who encouraged one member or all members of the BoD to commit certain actions or inactions resulting in the company's insolvency have personal liability vis-à-vis the company's creditors. The rationale behind this extension of liability to third parties outside the *stricto sensu* corporate organs is based on the assumption that although *de facto directors* (i.e. shareholders, financiers) may not have direct dealings with the company's creditors, nonetheless they have the obligation to take care of the creditors interests (see below, directors' duties in the vicinity of insolvency) and to make sure that creditors will not suffer losses due to delays in the declaration of the company's bankruptcy or the declaration of the bankruptcy.[35]

[31] See, Kokkinis, supra, p. 366.
[32] See, Marinos D. [att.], supra, DEE 2000, p. 865; Kokkinis, supra, p. 365.
[33] See, Stathopoulos, General Principles of Contract Law («Γενικές Αρχές Ενοχικού Δικαίου»), 2004, p. 1005.
[34] See, Rokas N, op.cit., p. 324, where the author states that acts made by the Board of Directors are binding on the company even if its period in office had already expired as long as these acts are approved either by the new Board or the General Meeting.
[35] See, Tzouganatos, "Recent approaches in shareholders' liability under public companies: Farewell to the liability due to lifting the veil of the legal entity" («Νεότερες αντιλήψεις για την ευθύνη των μετόχων ΑΕ: Αποχαιρετισμός της ευθύνης λόγω άρσης της αυτοτέλειας του νομικού προσώπου») in: «Τάσεις και Προοπτικές του Δικαίου της Ανώνυμης Εταιρείας» (18ο πανελλήνιο συνεδριο εμπορικου δικαιου (Καστορια, 2008), p. 179 et seq.

3 THE SCOPE OF DIRECTORS' DUTIES UNDER GREEK LAW

The Greek legal regime on directors' duties was going under reform for some years now (L. 3604/2007, L. 3853/2010, L. 3873/2010 and L.3884/2010) in order to comply with the relevant European legislation and ultimately to monitor more effectively the people managing a public limited company (this is an attempt which started with L. 3016/2002 on Corporate Governance, which includes special provisions on the management and the operation of listed public limited companies). Under the new legal framework the interference of administrative authorities on the establishment and functioning of public companies is significantly limited, shareholders' position is enhanced within the company, there is greater flexibility regarding the provisions that can be included in the company's articles of association, the taking of business decisions is facilitated as well as the procedure of the establishment of the company is simplified, and last but certainly not least, very important issues on the duties-liabilities question for members of the BoD are reviewed (such as the introduction of a business judgement rule), which provides members of the BoD and directors (art. 18 para 2 and 22 para 3 of L. 2190/1920 used as legal basis for proportional application of the BoD's duties-liabilities to directors as well) a wider margin of appreciation in the company's management (a minimum level of discretion regarding business decisions is now available). However, as Prof. Sotiropoulos notes "*the real Greek problem does not relate to the shielding of members of the BoD from extremely high liability, but on the contrary to the protection of the company and of those relating to it from bad management"*.

In this context, one may assert that the new legal framework on directors' duties and liabilities has changed the directors' position within the company, creating a less rigid, strict environment for them to work in, however it has not inserted significant changes with reference to the protection of the company from the possibility of bad management. On the other hand, Greek courts while applying these new rules, and trying to re-identify directors' duties and liabilities under the new framework in fact reiterate the principles formulated in the previous regime, as it is clear from the number of decisions, which for the time being remains rather small (Athens Court of Appeals 1089/2011, Piraeus Court of Appeals 357/2011, Supreme Court 350/2011).

From an Insolvency Law perspective (the Insolvency Code was also reformed, L. 3588/2007 and L. 4013/2011 on pro-insolvency procedures, restructuring plans), members of the BoD may have civil and criminal liability for two reasons: intentional delay in filing for bankruptcy, and bankruptcy of the company caused by intention or gross negligence. Apart from the members of the BoD, the Insolvency Code extends its scope of application to persons inciting the members of the board not to file in time for bankruptcy (art. 98 para 1 (2)) or influenced the members of the BoD to act in a way that caused the company's bankruptcy. Generally, third parties (employees, creditors and not just shareholders for example) are better protected under Article 98 compared to L. 2190/1920, however the enforcement of such claims is only possible via the liquidator, unless (in the prevailing opinion) the damage was suffered by an individual creditor (as opposed to all creditors).

However, despite the fact that at first instance the protective mechanisms of Insolvency Law seem to be more extensive, in fact they relate to a totally different phase in a company's life, hence it is not possible to reach a conclusion regarding the question of whether these rules are indeed more important than the ones of L. 2190/1920. Both sets of rules are of significant importance and only their cumulative application can reach to truly fair results for the persons suffering damages due to bad management by members of the BoD or directors of a public company.

3.1 Types of directors' duties

The system of provisions governing duties and liabilities of the board of directors is quite complex.

The fundamental statutory rule for the issues relating to directors liability is art. 22A of the Law 2190/1920, according to which: "every member of the board of directors is liable against the company for negligent management of the company's business affairs." The liability is not conditional on the validity of a director's appointment, meaning that even where the appointment of the director is void, liability would still attach[36]. Thus, *de facto* directors receive equal treatment (from a civil liability point of view) to *de jure* directors.[37]

The scope of Article 22a covers only issues of directors' liability against the company as a legal entity and not against third parties[38]. It should be noted, however, that not only directors may face liability for their actions, but the company itself may be also liable for its director's acts (vicarious liability).[39] Generally, directors are not personally liable for acts relating to the exercise of their duties *vis-à-vis* third parties. Nevertheless, this rule knows certain exceptions; for example: Law 2523/1996 and Law 1884/1990 (certain taxation offences), art. 1 of the Necessity Law 690/45 (where the managing director has criminal liability for non-payment of completed pay-for work) and other offenses, like those provided in art. 3 of the Royal Decree 25.8/5.9.1920 on issues relating to the hygiene and safety of employees at work.

The legal framework applicable to the board of directors as a corporate organ and to its individual members is quite extensive; relevant provisions especially regarding directors' liabilities are included in the Civil Code, the relevant statute for the listed companies, the Insolvency Code, and several statutes on financial, labour, tax and insurance law.

We can divide the applicable statutory rules to four categories:

The first and probably most important category concerns the fundamental statute on the role, duties and liabilities of directors is Codified Law 2190/1920 where the role, the duties, the function, and the liabilities of the board of directors (art. 18-24) are regulated (see especially Art. 18-24). The relevant provisions about the board of directors are quite dispersed in the various chapters of Codified Law 2190/1920 (art. 3a, 7b, 11, 13a, 18 ff., 34, 39 etc.). In addition, the Civil Code is applicable and includes general provisions on legal entities, and most importantly on agency relationship and mandate (or procuration) relationship.

[36] See, Passias, supra, p. 627; Markou, supra, p. 583-584.
[37] See, Markou I., "The character of the legal relation of a director in the public company - Attempt to construe this relation under the light of civil law", EllDni, 2000, p. 310
[38] By third parties we mean shareholders or employees of the company. For the latter, directors are liable based on the general liability provisions of the Civil code, see Athens Multi-member Court of First Instance decision no 2821/32, Dki 1932, p. 354.
[39] See, Supreme Court 194/76, ArchN 1976m p.141 and NoV 1976, p. 718. See, also Passias, supra, p. 625; Alexandridou E., *Law of commercial companies*, vol. B, 2nd ed., Thessaloniki, 2000, p. 93.

The second group includes special provisions emanating from the "law of listed public companies"; these are provisions entailed in both corporate law and securities regulation.[40] More specifically, a listed company is subject primarily to the general rules regulating public companies and is further subject to a special group of provisions given its special nature relating to corporate governance – in particular Law 3016/2002 or special obligations or prohibitions regarding market abuse (see, Law 3340/2005 "for the protection of the market place from any acts of persons having preferential information and market abuse acts" Government Gazette A'112/10/5/2005)[41]. Under Article 2 of Law 3016/2002 the members of the board of directors have a duty to pursue continuous improvement of the company's value and protection of its general corporate interests. At the same time, directors are not allowed to pursue personal interests to the extent that the latter contravene the company's interests and they have a duty to disclose those personal interests to the rest of the board members.

The third group includes provisions applicable to special types of companies. This is the case for financial institutions, that under Bank of Greece Governor's Act no 2577/2006 or the publicly owned public companies as defined in article 1 of the Law 3429/2005.

The fourth group includes several provisions from a huge range of statutes regulating liability of the BoD as a whole, as well as of its individual members, like the Insolvency Code (see, art. 98 of Law 3588/2007, Government Gazette 153/10.7.2007 about criminal and civil sanctions for the BoD), Competition Law provisions (art. 44 of L. 3959/2011) and tax, labour and insurance law rules as well as provisions against cartels (control over prices)).

3.2 Duty of diligence of the prudent businessman (duty of care)

The fundamental legal basis for directors' liability can be found in Articles 22a and 22b of Law 2190/20. More particularly, according to Article 22a a director is not liable if he acted in a diligent way as a "prudent businessman". An *a contrario* analysis of this rule leads to the conclusion that a director has a duty to act in a "prudent, due care way in relation to the company's affairs" and to promote the general interests of the company. This particular form of "duty of care" entails "due care" management of the corporate affairs both internal and external (third parties). Also, directors have to make sure that the company is abiding by all relevant statutory provisions in relation to the company's 'corporate structure' and its operations at all times, and to ensure that the other corporate organs (i.e. the general meeting of shareholders as well as the internal auditors) as well as third parties (in particular creditors) receive all relevant information. In this context, a director is responsible not only to manage the company with due care, but also to monitor the general management of the company by the other directors, in other words to ascertain that the compliance level of the management is in line with the legal mandates. Furthermore, the board of directors collectively, hence every director on an individual level has a duty to pursue the economic prosperity and welfare of the company. A director has to make a decision based on the "correct business decisions according to the accepted micro-economic criteria" while following the "correct" process.[42]

[40] See, Augitidis, *Listed public companies* (greek), p. 13, where the author notes the co-relation between these two legal subjects with reference to the public company and the protection of shareholders/investors; see, Perakis, DikAE, 1, 2002, Introduction I, no. 4, Rokas N., *Business Companies*, p. 485 et seq.
[41] See, also Augitidis, supra, p. 13.
[42] See, Marinos M.-Th., "On the applicability of article 69 of the Civil Code in the case of public companies", Diki, issue 2003, available at http://www.kostasbeys.gr/articles.php?s=5&mid=1479&mnu=3&id=17116.

3.2.1 Duty of loyalty

As a starting point, the Greek legislator tries to tackle the problem of "conflict of interests" via various mechanisms, such as imposing absolute prohibitions over certain actions and limitations over certain transactions even if they would not necessarily lead to direct damages for the company (preventive mechanism) and imposing a duty to inform the company (the rest of the BoD members) when such conflicts of interests have arisen (art. 22a para 3(b) of L. 2190/1920), in order to ensure a sound decision-making process in BoD's meetings.

According to Article 2 of Law 3016/2002 on Corporate Governance, "members of the board of directors as well as any third party to who the board has assigned part of its powers are not allowed to pursue personal interests in contravention with the ones of the company" (see also Article 22a § 3a of Law 2190/1920). Duty of loyalty is being construed as a special aspect of the general rule of *good faith* and the prohibition of *abusive behaviour* as stipulated in article 288 of the Civil Code.[43] In line with this, every director has a duty to foster the company's economic prosperity while avoiding any actions or inactions that would benefit the director's personal interests, if the latter are not compatible with the interests of the company. In other words, the duty of loyalty works as a mechanism for the resolution of the "conflict of interests" problem and exercises control over the BoD by all other corporate organs.[44] Based on the duty of loyalty one can list a number of situations that are deemed to constitute an *a priori* "conflict of interests" and subsequently may lead to direct or consequential damages for the company:

- Self-dealing;
- Decisions on the remuneration of members of the board of directors;
- Inside trading;
- Prohibitions on competition and exploiting business opportunities in the company's expense;[45]or
- Interlocking directorates, especially in the case where the member of the board of directors is director or member of the board in a competitor or affiliated company; in this case, it is quite possible that article 69 of the Civil Code is triggered, which would result in the temporary management of the company to other directors, assigned by Courts[46].

These are deemed as aspects of the "negative" side of the duty of loyalty, meaning that a director is obliged to omit actions in his favour or in anyone else's but the company's which could potentially lead to a breach of its duty to fulfil the company's objectives.

3.2.2 Differences between the duty of care and duty of liability

One may assert that the duty of loyalty is a special aspect of duty of care. As it is stated in Articles 22a Law 2190/1920 and art. 26 of Law 3190/1955 for limited liability companies, duty of care emanates from the same principle as duty of care; the obligation to promote and realise the corporate objectives by corporate organs.

[43] See, Marinos, Prohibitions on competition, supra, p. 57 et seq; Rokas N., p. 72.
[44] See, Marinos, ibid, p. 119 et seq.
[45] See, Marinos, ibid, p. 170 et seq.; Athens One-member Court of First Instance decision no 7954/2000, EllDni 2002, p. 250; Athens One-member Court decision no 249/1996, EEmpD 1997, p. 525.
[46] See, Athens One-Member Court of First Instance decision no 22673/1993, EEmpD 1995, p. 62.

Nevertheless, these are two distinct duties with a different scope of application. The duty of care (prudent management) deals with the management of the company. The corporate organs have to ascertain a certain degree of organisation and monitoring of the corporation, in order to avoid that the company suffers damages. Directors individually and as a collective corporate organ have to decide upon what is in the company's best interest, i.e. every decision made by the BoD must be in accordance with the company's objectives and interests, and directors must take responsibility for the underlying business risks and respect their duty of disclosure of important information to the shareholders. Generally, directors have a wide discretion, which can only be challenged before the courts in exceptional circumstances (for instance, fraudulent behaviour in the director's own interests to the detriment of the principal), and exercise substantial control over companies.

The duty of care ("diligence of a prudent businessman") is deemed to be an *ex ante* behavioural standard, and the law (art. 22a para. 3) uses an objective tool, the criterion of "an ordinary manager", to assess compliance with this standard. An ex *post* court review, based on the outcomes of a particular managerial action as the basis for liability would lead to excessive liability, since it would result in directors essentially being liable for taking commercial risk. The *ex ante* nature of the assessment of managerial conduct is also accepted by the Greek legislator and the courts.

One of the new concepts introduced to Greek corporate law by L. 3604/2007 concerns the business judgment rule. Prior to the changes inserted with L. 3604/2007 the outdated legal framework on directors' liability included the so-called "prudent *pater familias*" criterion under which a director had to show the same level of due diligence for the company's business affairs as for its own household's. This was then replaced by the "*prudent businessman*" criterion. In addition, under the previous framework, a CEO could face "special liability" (only CEOs were exposed to higher liability), but *post* L. 3604/2007 there are different levels of directors' liability based on their position and tasks in the company (under this regime, even non-executive members of the BoD may be held accountable for breach of their duties). The most important difference, however, relates to the issue of the Business Judgement Rule (BJR (Article 22a para 2 (c)) under which directors are excluded from liability when:

- They can prove that their business decisions were in conformity with the company's interests;
- They were acting in good faith (i.e. their behaviour must be in accordance with their duty of loyalty, meaning that their decisions must not be based on their own personal interests, third parties' interests or the BoD's interests but on the company's[47]); and
- They had sufficient information (this requirement is examined by courts *ad hoc*).

The rule has its origin in US corporate law and aims at limiting directors' exposure to liability when regularly taking high business risk in performance of their duties. In this context, the BoD can take business risks without being exposed to liability when it is acting within the scope of the so-called *"prudent management."* In other words, directors responsible for failures or bad business choices do not necessarily have to face liability concerns. Provided that the directors acted according to the *"prudent management"* mandate and that the relevant decisions were made in good faith and with sufficient information, as stipulated in the Law 2190/1920, directors are exempted from liability claims under the BJR.

[47] See, Athens Court of Appeals, 4860/06, EEmpD 2007.590, Athens Multi-member Court of First Instance 419/05, EEmpD 2005.308.

On the other hand, duty of loyalty aims at the prevention or the restitution of damages that could be caused due to "conflict of interests." Setting out certain types of behaviour by the directors and members of the board (for example, prohibition of competitive behaviour, non- disclosure of corporate secrets etc.) is more "objective" and therefore easier to prove contrary to the breach of duty of "diligent and prudent management." The fundamental difference between these two types of duties shows that the duty of loyalty and the duty of care under the Greek legal framework are two separate duties owed by directors to the company. It should also be noted that in line with this, bad management is not construed as a "conflict of interests" but courts examine whether liability could be established under the scope of the duty of care.[48]

3.2.3 Duty of disclosure of information

According to Article 2 para 3 of Law 3016/2002 (see also art. 22a § 3b of Law 2190/1920),[49] the duty of disclosing information requires all members of the board of directors to provide all necessary information to the rest of the BoD's members.[50] In the event that one of the members refuses to abide by this duty based on the relevant case law it is clear that the courts accept the possibility of forcing these members to disclose necessary information to the other members by imposing provisional measures if necessary.[51] In this case the action to obtain interim measures would be brought against the company.[52]

The duty of disclosure provides that no member of the board of directors may pose obstacles to the others, by withholding important information to itself regarding the company's business affairs.[53] The rationale behind this duty relates to the facilitation of the exercise of directors' duties and is considered as a counter-measure against directors' liability. It is also based on the collective nature that characterises this corporate organ.

The extent of this duty is defined *ad hoc*, meaning that each member has the right to be informed about all the business affairs of the company, even if they, for example, fall outside the scope of the agenda set by the board[54] during its meetings[55]. Nevertheless, the exact scope of information and the way of disclosure depend on the particular issue concerned. In the case of CEOs some accept that they are excluded from this duty since their official capacity creates a direct relation with the company and the company only, hence their liability can only be established for breach of their explicit or implicit agreements with the company. Thus, a CEO has no duty to disclose information to the rest of the board members[56]. It should be mentioned, however, that this view is not generally accepted, since it

[48] See, Athens One-Member Court of First Instance decision no 5706/1988, EEmpD 1988, p. 623; Athens One-member Court of First Instance decision no 4345/1996, EllDni 1996, p. 208; Athens Court of Appeals decision no 1173/1983, EEmpD 1972, p. 223.

[49] The duty to inform under art. 22a § 3b refers to the conflicts of interests; a general right of the directors to be informed about the company's affairs is not covered by this provision.

[50] See, Perakis E., *Informing the members of the Board of directors*, Vol. a,, Afoi Sakkoula, Athens, 1996, p. 747 et seq.

[51] See, Supreme Court 806/94, DSAE/EPE 1995, p. 21; Athens Multi-member Court of First Instance 5492/54 EEmpD 1954, p. 255; Athens One-member Court of First Instance 27388/95 DEE 1996, p. 810 see comments by Mouzoulas S.; Athens One-member Court of First Instance 2997/95 EEmpD 1995, p. 244; Thessaloniki One-member court of First Instance32018/95 EEmpD 1995, p. 244.

[52] See, Perakis, supra, p. 762.

[53] See, Athens One-member Court of First Instance 2997/95, supra, where the Court distinguishes between the duty of disclosure on directors against the other members of the Board from the duty to exercise control, where the company has the duty to provide sufficient information to the directors. Based on article 495 of the Civil Code it is asserted that "beneficiary" to this duty is the Board as a collective organ, and not every director individually, see Perakis, supra, p. 761.

[54] See, Athens One-member Court of First Instance 2997/95.

[55] See, Supreme Court 806/94.

[56] See, Georgacopoulos L., Liability of Board of directors for transactions with subsidiary company, in The law of coporations, vol. IV, supra, p. 231-232.

ignores the nature of the board of directors as a collective corporate organ responsible for the management of the company[57].

Furthermore, this duty cannot be excluded or limited in the company's Articles of Association[58]. Finally, this duty should not be confused with the right to be informed, a right which under art. 39 of L.2190/1920 relates to minority shareholders' rights.

3.2.4 Duty of confidentiality

Duty of confidentiality applies to all members of the board of directors and includes primarily sensitive information disclosed to directors during their term in office due to their official capacity. If they acquired confidential information from another source, in the event of disclosure it may not be a breach of duty under article 22a para 3 of Law 2190/20 (duty of confidentiality), but it is possible to establish liability due to infringement of another duty[59].

The duty of confidentiality, however, does not preclude the possibility of disclosing important information in the general meeting of shareholders if it is vital for making a decision. In this case, non-disclosure of such crucial information can create liability for the board of directors. Hence, disclosure of confidential information in the company's interest is admissible. Duty of confidentiality is not contrary to duty of disclosure of information (to the rest of the BoD members), since under this duty only relevant information during the business-making process should be disclosed.

Finally, duty of confidentiality does not cease even after the end of the director's term. The actual termination of this duty is determined on a case-by-case basis[60].

3.2.5 Duty to pursue the corporate objectives

Article 1 of Law 3016/2002 provides that members of the board of directors in listed companies have a fundamental duty to pursue growth and add value to the company and the fulfilment of the company's objective. In other words, directors have to protect the company's interests and promote its objectives even if it means that they need to assume risk (for example liability risk) when making a business decision (Ar. 22a L. 2190/1920, ar. 2 L. 3016/2002)

3.3 To whom are the duties owed?

Directors provide independent services, unless they perform additional tasks under a dependent services contract. A member of the BoD has two different relationships with the company; as a member of one of the company's "corporate organs", a relationship that starts from the day of the member's appointment and includes the power to represent the company as well as to manage its business affairs, and as a provider of dependent services (if the member of the BoD receives payment for its services) to the company, a relationship which starts from the point that the contract sets out.

[57] See, Perakis E., The law of public company, p. 105, Nomiki vivliothiki ed. 2000, Athens.
[58] See, Athens Multi-member Court of First Instance 5492/54, EEmpD 1954, p. 255.
[59] See, Passias, supra, p. 677.
[60] See, Levantis, supra, p. 554 in fine.

An illustrative example is the Supreme Court's decision 87/2009 where it is stated that the managing director (CEO) of a public company "under articles 23a, para 2, and 24, para 3 of Law 2190/1920 regarding "Public Companies", and 713, 648, 652 of the Civil Code, has an agency relationship with the company. If the director is remunerated for delivering services, this could be construed as an underlying independent services relationship. However, it is possible that a director apart from its agency relationship with the company may also have an additional dependent services relationship, for instance if the director after its appointment by the general assembly assumes further duties beyond those considered as regular in the course of its relationship with the company and beyond those imposed *ex lege* or by the company's articles of association, and these particular tasks are performed under the instruction and control of the company (board of directors), even if in the course of these tasks the director takes initiative"[61]. Hence, due to their relationship with the company, directors owe their duties to the company and not to shareholders.

3.4 The director as a shareholder

If a member of the BoD also holds in his name the majority shares in the company, in a way that it fully controls the BoD's decisions then this director can be deemed to have acquired the so-called "commercial status"(«εμπορική ιδιότητα») and should be registered with the Commercial Registry/Trade Registry (like parties to personal companies). In this context, if a member of the board that holds the controlling shares in the company is practically using the legal entity essentially as a corporate veil against *bona fide* third parties , then it is possible that this director will acquire "commercial status."[62]

In the event of a "conflict of interests" between the company and the members of the board of directors, Article 69 of Civil Code may be invoked, which provides the appointment of a temporary management by the courts. In order for this procedure to take place, anyone with a "legal interest" may file a petition requesting the appointment of a temporary management in the company.[63] There is no such conflict of interests, where the competing interests involve solely different shareholders.[64] In addition, appointing a temporary management is not permissible, when the "conflict of interests" relates only to one member of the board, whilst there is still a quorum with the remaining members.[65] It should be mentioned, that Article 69 does not apply to either duty of care or loyalty, thus it cannot be triggered in cases of bad management.[66]

3.5 The time span of the duties

Duties of the members of the board of directors commence at the time of their appointment by the general meeting and not at the time of actual assumption of office[67]. The publicity requirements in art. 7a (c) of L. 2190/1920 have only declaratory (and not constitutive) power. They do, however, play a pivotal role in the company's relation with third parties, since the company may only invoke the

[61] See also, Supreme Court decision 907/1198.
[62] See, Athens Multi-member Court of First Instance 739/98 EEmpD 1998, p. 795.
[63] See, Thessaloniki Court of Appeals 3570/90 EEmpD 1992, p. 75; Athens One-member Court of First Instance 5706/88 EEmpD 1988, p. 621.
[64] See, Athens Court of Appeals 621/83 Arm 1984, p. 213.
[65] In this case, art. 66 of the Civil Code applies providing that this particular member cannot vote with reference to the decision for which he has interests. See, Patras Multi-member Court of First Instance 539/52, EEmpD 1952, p. 257.
[66] See, Patras Court of Appeals 226/97 DEE 1997, p. 591.
[67] See, Supreme Court decision 579/91 Dni 1972, p. 339; Supreme Court decision 87/74 NoV 1974, p. 901.

appointment of the directors against third parties after the publication in accordance with this provision. This applies even if the directors' appointment is invalid as long as third parties were not aware of this fact (art. 7 e of L. 2190/1920; but see art. 7b § 13).

Furthermore, the duty of loyalty also covers directors of a company under establishment, as well as its liquidators.

For a 'reasonable time' after the end of the relationship out of which the duty of loyalty emanates (i.e. when the director ceases to hold its position), the duty may still apply (art. 23 in conjunction with art. 288, 281 of the Civil Code). In other words, after the end of the director's official duties, the duty of loyalty ceases, however based on the particular circumstances of the case, it may extend for a 'reasonable time' (cumulative application of art. 23 and art. 288,281). A longer extension may be achieved via a clause on "post-contractual prohibition to abstain from competitive actions" included in the directors contract with the company. For example, in the case Athens Court of Appeals case No. 5131/2011, the court accepted that a two-year extension of this prohibition is lawful (there was, however, a valid agreement on "post-contractual prohibition to abstain from competitive actions" included). In such cases, the court examines whether the timeframe set is in fact abusive (inter alia the court reviews the time, the territory to which it extends, as well as the nature of the prohibited business actions). Similarly, the Supreme Court[68] has accepted that such clause may be lawful.

3.6 Application of duties to *de facto* and shadow directors

As mentioned above (see section 0), directors' duties also apply to de facto directors. In this context, the Greek Courts define *de facto* directors as individuals who "exercise the real direction and management of the company's business affairs."[69] Generally, it is accepted that if the company's financial position is worsened by the acts of a *de facto* director interfering with the BoD's decisions and causing damages or even insolvency to the company, then the latter may bring an action against the former for civil liability under Article 914 of the Civil Code[70] and art. 98 of the Bankruptcy Code.

[68] See, decision no 797/2010.
[69] See, Supreme Court decision 1562/1999, DEE 2000.
[70] Ibid.

4 LIABILITY FOR BREACH OF DUTY

Liability of directors emanates mainly either from a statutory provision or the company's articles of association. According to Article 22a paragraph 2 of L. 2190/1920 (as amended by article 30 of L. 3604/2007) and article 3 of L. 3873/2010 (for the cases of errors in the company's financial statement) members of the board of directors have joint and several liability (or *all claims* liability) only if they acted collectively, i.e. the company may turn against each and every member of the board for a negligence behaviour. In this case, every member of the board has personal liability and will have to compensate the plaintiff (the company) for the total damages caused by the actions or omissions of the board as a whole (the defendant must then turn against the other members of the BoD for contribution to their share of the liability). This is a *ius cogens* rule, meaning that any attempt to circumvent it will be deemed as null and void.

In order to hold members of the board jointly responsible for all the damages sustained by the company, they should be either joint tortfeasors, or at least have acted in a similar tortious way. If the delict occurred due to the actions or omissions of a member of the board of directors along with a third party, then the latter can be prosecuted too (joinder defendant). The combination of articles 714, 297, 298, 914 and 919 of the Civil Code makes clear that members of the board of directors are liable for any intentional or negligent act or omission that caused damages to the company in the course of their management.

Pursuant to Article 22b para 1 of L. 2190/19290 the general meeting or minority shareholders who hold shares accounting for 10% of the company's capital, have the right to require from the company to bring an action for damages against the specific members of the board. If the losses suffered are the result of the directors' fraudulent behaviour, the action has to be brought in the company's name directly, without any prior request made by the general meeting or minority shareholders. The right of minority shareholders under article 22b of L.2190/1920 (as amended by Article 31 para 2 of L. 3604/2007) is a mandatory rule of Greek company law, meaning that it cannot be limited or excluded in the company's articles of association. Articles 18, 22a and 22b of L. 2190/1922, as well as articles 68, 714, 297 and 298 of the Civil Code establish that members of the board of directors are held liable to the company for breach of their duties, which as aforementioned emanate either from their contractual relationship, a statutory provision or from the company's articles of association, or for breach of their "self-contained" duty of loyalty, as long as the company suffered damages (under articles 914 and 919 of the Civil Code that establishes a direct and self-contained obligation for compensation).

According to Article 23 para. 1, 2 and 3 of L.2190/1920, directors participating "in the company's management" are prohibited from engaging in any commercial activity within the field of the company's operations without the prior consent of the general meeting. This prohibition applies to both, commercial activity carried out in the directors' own name and on behalf of third parties. The company has to enforce this right within one year of becoming aware of a breach of this duty, and in any case within five years of the breach.

4.1 Duty of care: conditions for liability

Generally, under Article 22a of the L. 2190/1920 directors face negligence-based liability for any damage caused to the company. More specifically, according to art. 22a, para. (1) directors are liable for negligent performance of their managerial duties. On the other hand, para. 2 of the same article reverses the standard burden of proof by stating that no such liability exists if the director proves that he showed the "due care/diligence" required under the circumstances; in our case that would be the care and diligence of a "prudent businessman" (it used to be "prudent *pater familias*" prior to the modification of this provision by L. 3604/2007).

Furthermore, after the relevant amendments in Law 2190/20 (by Law 3604/2007) the benchmark for determining liability for each director is its position in the company and its exact tasks.

Thus, under the present version of L. 2190/1920 in order to attribute liability to a director one should first determine the latter's tasks, duties and obligations which should always be exercised in conformity with "the company's interests" (this is a notion that includes mainly the interests of the shareholders, and to a second degree several additional interests). Under Greek law and in line with the BJR there is no exhaustive list of indications for what constitutes a "good business decision," but they must all be in conformity with the general principles of "prudent management," "fair and honest business practices" and the "protection of the company's interests." Depending on the company's size, its objective, whether it is listed or not the range of liability differs.

It should be mentioned, that the legal regime on liability established under civil, administrative and criminal statutory provisions for reasons listed above apart from those articulated in L. 2190/1920 is relatively complex, and frequently provisions from all these legal subjects tend to overlap. Furthermore, the general rule of attribution for offenses conducted by directors is the extent of "real participation" or *de facto* participation of a member of the board of directors in the management of the company (compared to that of the representative of the company). In exceptional circumstances, personal liability of shareholders in public companies may be also established for debts or breaches, although as a general rule shareholders are not personally liable for the actions or inactions of a public company (the legal person has a separate legal personality, hence separate liability from its shareholders).

4.2 Duty of loyalty: conditions for liability

Article 23a of L. 2190/1920 contains certain restrictions on directors dealing with the company. This includes, in particular, the provision of loans (as well as guarantees or securities for loans) to directors, and more generally any contract between a director and the company outside the company's usual business. Except in the case of loans to directors, contracts between the company and its directors may, however, be concluded if the general meeting approves the transaction. The approval has to be given by a majority of the shareholders, but minority shareholders holding at least 33% of the votes can veto the decision. In cases of retrospective ratification, 5% of the shareholders can exercise this veto right. The provision applies irrespective of any damage to the company.

Similarly, the prohibition of competition in Article 23 can also be waived by the general meeting. Article 23 refers to directors of a public company (including *de facto* directors, members of the board of directors appointed under art. 18 para 3 of L. 2190/1920, as well as “temporary directors” under art. 69 of the Civil Code). As mentioned above, it is not essential that the director has an active role in the day-to-day management of the company.

Although the company cannot generally forfeit its rights established under the duty of loyalty, which they are owed by directors to the company, it is possible for directors to compete with the company if they obtain the general meeting’s approval. In any event, obtaining the approval of the general meeting *ab initio* or *ex post* does not mean that directors’ liability for breach of the duty of loyalty is extinguished and in no case should this provision be deemed as an *in blanco* permission to directors to be intentionally engaged in acts that result in damage to the company’s interests or to exploit inside information, for example, without having to face any consequences. Thus, despite the general meeting’s approval the company can bring an action against the director for damages (article 914 of the Civil Code- general tort law provision- in conjunction with art. 23 of L.2190/1920) for *lucrum cessans* in particular. The burden of proof lies with the company, which should also establish why this action is competitive to its own interests and is time barred one year after the announcement of the action and in any event after five years.

It is worth noting that Articles 22a and 22b on the issue of forfeiture of claims by the company are deemed *lex speciales* provisions to art. 23 and perform a complementary function to the latter rule.

4.3 Exemptions and limitations

Establishing liability of directors can be a quite demanding task, since it is established upon “variables”, abstract notions like that of the “prudent businessman” as stated in Article 22a(2) of Law 2190/20, or the notion of “misconduct”, which is described as a behaviour that would not be adopted by a “prudent businessman”, i.e. a person who would have taken precautionary measures in order to avoid negative externalities on third parties.

The company’s articles of association cannot exclude liability of directors. In this context, any provision in the articles of association precluding liability is not valid, not even for the case of negligence.[71] There is however a possibility of waiver under art. 22a para. 4 and 35 of Law 2190/1920.[72] Moreover, any clause in the company’s articles of association stating that the company may require from its directors payment of a certain amount of money for breach of their duties via “penalty fees” is unlawful[73]. Any kind of agreement exempting or limiting *ex ante* directors liability even in the case of minor negligence is deemed to be unlawful as well. In line with this, any *ex ante* decision of the general meeting exempting directors from liability would be deemed null and void, since it would contravene art. 22a para 4.[74]

According to Article 22a (2) subclause 2 of L.2190/1920, directors cannot be held liable for actions that were based on lawful decisions of the general meeting[75].

[71] See, Athens Court of Appeal, decision no 10725/79, NoV 1980, p. 1186 and EEmpD 1980, p. 605.
[72] See, Karavas, supra, p. 447; Georgacopoulos L., *The law of companies*, Vol. III, Athens, 1974, p. 143.
[73] See, Mouzoulas S., The application of freedom of contracts under public company law, EllDni 1995, p. 272 with relevant footnotes.
[74] See Rokas N., *The limits of majority powers under the law of public companies*, 1971, p. 304.
[75] See, Markou, supra, p. 599; Contra Rokas N., The limits, supra, p. 303-304.

According to Article 22a, paragraph 4 of L. 2190/20, a company may forfeit its claims for compensation against the members of the BoD or it may settle its claims if two years from the point that they became legally enforceable have passed with the approval of the general meeting (however if shareholders who control at least 1/5 of the company's share capital and are present at the general meeting object, any decision approving the settlement of these claims is considered invalid). In other words, only after two years from the date when the claim against the director became enforceable and only after approval of shareholders is it possible for a claim to be settled. It should be mentioned, that pursuant to Article 35 para 1 of L. 2190/1920 after the approval of the Annual Accounts by the General Meeting, shareholders are called to approve the discharge of the members of the BoD and Auditors, who audit the financial statements for that particular financial year, from any liability for compensation for the actions during that financial year. Nevertheless, as it is clearly stated this waiver does not extend to liability issues covered by art. 22a of L. 2190/1920.

Article 22a, paragraph 4 is deemed to be a *ius cogens* provision and in any event is *lex specialis*, meaning that Article 35 (1) of L. 2190/20 is only a complementary provision to the general rules in relation to forfeiture of claims by the company. In this context, if shareholders do not grant their approval with reference to forfeiture of claims or if for some reason the general meeting's decision regarding this issue is void, article 35 (1) will be still applicable.[76]

Amongst the ways that a member of the board of directors can cap liability or be excluded from it is when the member of the BoD provides sufficient proof that it showed the care and due diligence of a "prudent businessman." Alternatively, the member of the BoD has to prove that it did not take part in the common action or omission that caused damage to the company.[77]

4.4 Insurance against liability

Insurance against civil liability for the members of the board of directors is possible under Greek law. Available insurance policies normally cover exposure of companies and not personal liabilities of officers and directors. Nevertheless, the fact that they are exposed to a wide range of risks and given that under the past legal regime it was easier to establish tortious behaviour against members of the BoD made insurance against liability quite popular amongst directors. It is possible that the insurance contract is made either in the name of the company or in the name of a director. Insurance against civil liability covers the losses suffered by the tortious acts of directors either against the company or third parties.[78]

It is worth noting that insurance contracts cannot cover damages that were caused intentionally. Moreover, insurance is only available against possible future liability, and only where the occurrence of the insured event is uncertain at the time of the conclusion of the insurance contract.[79]

[76] See, Athens Multi-member Court of First Instance 7409/72 EED 1973, p. 522.
[77] See, Karavas, supra, p. 478.
[78] See, Varela M., in *Applications of Commercial Law*, Nomiki Vivliothiki ed., Athens, 2007, p. 1.
[79] Ibid, p. 6-11, 79 et seq.

4.5 Duration of liability

Since Article 22a of L. 2190/1920 refers to members of the BoD, the liability is generally linked to the holding of such office, and hence begins with the appointment and lasts as long as the director holds office.

Under Article 22a para 5 of L. 2190/1920, the claims are time barred three years after the commitment of the action. In case of intentionally caused damages, the period is extended to ten years. The time period starts from the time the act was committed. A special rule applies in cases where the director breaches the duty not to compete with the company. In this case, claims have to be enforced no later than one year after the company is made aware of the breach, and in any case in five years, under Article 23 para 3 of L. 2190/1920.

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 The meaning of 'vicinity of insolvency'

As a preliminary thought, pursuant to Article 72 of the Civil Code "when the legal entity is dissolved, is under liquidation; until the end of this process, it is still presumed as existing." As it is clear from the wording on this provision, a public company, like all legal entities governed by private law, is by "fictio juris" considered as "existing" and does not automatically cease to exist upon bankruptcy.[80] In line with this, Article 96 para 1 (2) of the Insolvency Code states that the corporate organs do not automatically dissolve in the event of the company's bankruptcy, but they lose to a certain extent their "position" within the company, since the insolvency administrator acquires an institutional role. In addition, the "company's interest" change from that point onward and the protection of creditors' interests becomes the main purpose. Members of the BoD and directors are still responsible for the internal affairs of the company, however they lose their power to manage the company's assets, as well as their absolute power to represent the company with reference to its external affairs.

Bearing this in mind, in order to determine liability on persons associated with the distressed company and especially to examine whether directors' duties change "in the vicinity of insolvency," we need to take a step forward and define the point when bankruptcy procedures commence. In this context, under Greek law bankruptcy starts from the point when the company ceased payment of its business debts or declared that the payments owed to its creditors are suspended and a court decision is issued. A written application has to be lodged along with proof in support of this claim by any creditor or the debtor itself. The debtor must file the application within one month of the cessation of payments.

From the point of cessation of payments to the company's creditors until the court's decision on the opening of insolvency proceedings, directors are personally liable for any losses to the company or its creditors due to any delay in the application to the court.[81]

Under this scope, it is clear that the term "vicinity of insolvency" does not merely cover the period between the cessation of payments and the declaration of bankruptcy (technically, the "suspect period"), but rather extends to a broader time period, i.e. from the time insolvency suspicions arise until the point when insolvency becomes irreversible. As a general remark, liability of directors of financially distressed companies has different levels of intensity depending on their incentives. Directors and members of the BoD may face liability not only for gross-negligence (delay in triggering their obligation to file bankruptcy proceedings), but even for mere negligence[82], since they have substantive discretion over the period between a going-concern and the triggering of the bankruptcy proceedings ("vicinity of insolvency"). In this context, the Insolvency Code imposes civil liability to directors for intentionally delaying to trigger insolvency proceedings (art. 98), while the same Code in art. 171 imposes sanctions to directors for intentionally bringing the company to a financial position

[80] See, Supreme Court decision 30/2010, EEmpD 201/618.
[81] See also, Mazis P., "Representation of a public company by insolvent individuals", EEmpD, 1988, p. 173-175.
[82] See, Kotsiris L., *Insolvency Law*, Sakkoulas publications, Thessaloniki 2011, p supra, p. 157.

where bankruptcy is inevitable and in art. 172 for discriminatory treatment, when the company is declared insolvent. Hence, directors, including de facto directors,[83] have to take all reasonable measures in order to determine whether the company's business is viable or needs restructuring. To that end, the BoD will have to hold regular meetings, review the company's financial position and the accuracy of its financial statements, supported, where necessary, by experts in the relevant fields. The directors will typically also enter into negotiations with the company's major creditors.

Directors who fail to take the aforementioned reasonable steps to ensure that the company only continues its operation if and to the extent the company's business is viable are exposed to liability for any damage caused by the failure to take such steps.

Finally, as regards enforcement of liability claims, it is worth noting that following the commencement of a bankruptcy or reorganisation procedure, the main focus of the insolvency administrator is the preservation of the company's remaining assets and its distribution to the company's creditors; claims against officers and directors shall mainly be raised to the extent necessary to increase the assets available for distribution. Nevertheless, based on the relevant case law, liability of the managing director of a company is not prejudiced by the termination of its office or the placement of the company under bankruptcy status.[84] Similarly, liability of the officers for company debts towards the Greek State and state entities is not prejudiced by the fact that the company is under liquidation.[85]

5.2 Change of existing duties

The insolvency of a company does not automatically mean that directors or members of the BoD lose their offices in the company.[86] In addition, the insolvency of a public company does not result in the suspension of a director's duties, since under this corporate form directors do not become personally insolvent as a result of the company's insolvency[87] (like in the case of general partnerships). [88]

Directors' duties may continue to exist as usual even during the liquidation period of the company. Nevertheless, their duties shift when the liquidator assumes its own duties. Hence, until the appointment of the administrator if the board of directors fails to take action especially in relation to urgent business affairs for the company due to negligence[89], then its members may be still face liability as they would have if the company was still liquid[90].

[83] Ibid, p. 159-160.
[84] See, Decision of the Pireaus Administrative court of First Instance no 1/93, NOMOS.
[85] See,. Decision of the Supreme Court no. 249/98, NOMOS.
[86] See, Passias, supra, p. 513; Karavas, supra, p. 378.
[87] See, Athens Multi-member Court of First Instance 3281/60, EEmpD 1960, p. 402.
[88] See, Anastasiadis H./Rikas K., *Greek corporate law*, vol. I, 5th ed., Athens, 1949, p. 371.
[89] See, Karavas, supra, p. 376 in fine 377.
[90] See, Karavas, supra, p. 376 in fine 377.

5.3 Newly arising duties

5.3.1 Duty to file for bankruptcy

According to Article 98 of L. 3588/2007 the members of the board of directors that are responsible to file for the commencement of bankruptcy proceedings are liable for any delay that caused losses to creditors (from the due day to the day of actual filing). Similarly, anyone encouraging such behaviour to the members of the board may be liable as well. If the company became insolvent due to the directors' actions or inactions (committed intentionally or due to gross negligence), then they may be face joint and several liability.

If the application for bankruptcy, which officially launches the bankruptcy proceedings is not timely, the members of the board who are responsible for this delay are liable for damages to corporate creditors over the debts created by the day the application should have been submitted until the declaration of the bankruptcy of the company. If the company's bankruptcy was caused by malice or gross negligence of members of the board, directors shall be liable for damages against the company's creditors (in a way, this is similar protection to the protection against "wrongful trading").

Based on these provisions direct personal liability of the directors is established under the condition that there is an actual damage to creditors. Personal liability for damages is based on the general principle governing the law, the duty of care and protection of corporate creditors: when the debtor is in a state of insolvency it is obliged to take into consideration its creditors interests because they are at risk.

Finally, it should be mentioned that the business Judgment Rule is not applicable in this case.

5.3.2 Other new duties

Under Greek Law, when the company is solvent officers and directors do not have any fiduciary or other duties towards third parties, including creditors and shareholders, by reason of their involvement in the management or representation of their company. Officers and directors may be held personally liable vis-à-vis third parties, including creditors, only for breaches of the law directly causing damages to them, that are causally connected with such breaches (torts), and to the extent the damages do not relate to claims of which they may seek satisfaction against the company. Nevertheless, from the moment that the company is declared insolvent, the corporate organs (board of directors and the general meeting of shareholders) are obliged to assist and cooperate with the administrator wherever it is deemed necessary (by the administrator), for instance give access to accounts, premises, otherwise they may be considered liable to the company's creditors[91]. Generally, the obligations of the board of directors shift gradually from the protection of the company and its shareholders to the protection of creditors as insolvency matures.

[91] See, Piraeus Court of Appeals decision 294/2008, NOMOS; Athens Court of Appeals 691/1995, NOMOS.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue

As part of their managerial duties, members of the BoD have the power to bring actions in the name of the company against third parties, including against its organs[92]. This power can be conferred to an agent or a third party if it is allowed under the company's articles of association and after obtaining the general meeting's approval.[93]

6.1.1 The company as plaintiff

The enforcement of a company's claims against members of the board of directors is regulated in Article 22b of L. 2190/20. Generally, the board of directors represents the company in its proceedings against the director. However, the general meeting may also appoint a special representative for the proceedings against the director.

The company has to enforce its claims against the director where the general meeting or the board of directors decides to do so, as well as in cases where shareholders representing 10% of the company's capital request the enforcement of the claim by the company. The articles of association may also give the right to request the enforcement of the claim to shareholders holding less than 10% of the company's capital. The requesting (minority) shareholders must have held the shares for at least three months at the time of making the request.

6.1.2 The shareholders as plaintiffs

6.1.2.1 In their own name

Since the duties are owed to the company, rather than to the shareholders individually, shareholders generally cannot bring claims against the directors based on a breach of duties. However, claims may be available based on general rules of tort law, provided the director has directly caused damages to a shareholder in breach of a duty established outside the scope of the duties owed to the company.

6.1.2.2 On behalf of the company ('derivative action')

Under L. 2190/1920 as amended by Law 3604/2007 no "derivative action" is recognised. However, where a request is made by the shareholders in accordance with Article 22b para 1 (as described above), the company is under an obligation to bring the claim against the member of the board of directors within six months.

[92] See, Piraeus Court of Appeals decision 416/99 EEmpD 2000, p. 85.
[93] See, Supreme Court 186/89 EllDni 1990, p. 334; Athens Court of Appeals decision 1179/87 EllDni 1988, p. 356.

If the company fails to bring the claim within this period, the shareholders may, within one month of the expiration of the six month term, file an application for appointment of a special representative with the relevant court. The special representative, if appointed by the court, may act on behalf of the company for the enforcement of the claim. The expenses for both, the appointment of the special representatives and the pursuance of the claims against the member of the board of directors are then borne by the company.

6.2 Criminal and administrative sanctions

6.2.1 Tax offences

The Chairman of the BoD, the CEO, or a director of a public company can be held in custody for the company's debt obligations owed to the Greek State, the Social Insurance Institute (IKA) or third parties (not private persons) under the Code for the Collection of Public Revenue (KEDE).[94]

Inter alia directors may face:

- Personal liability for income tax, VAT, turnover tax (FKE) and capital accumulation tax (FSK)[95];
- Penalty of prohibition of leaving the country (Greek citizens) for debt obligations owed to the Greek State[96];
- Criminal liability for debts to the Greek State and third parties (no private persons) for no-payment: This is a misdemeanour offence and the penalty is up to five years. The director must either be personally liable or in his official capacity as director or member of the Board of directors against the Greek State.[97]
- Criminal liability for tax evasion: Under Art. 20 (1) a of L. 2523/1997, in the case of a public company directors (including *de facto* directors) are deemed as perpetrators of tax evasion if showed intent.[98]
- Civil and administrative penalties for tax evasion: In cases of tax evasion public authorities (tax authorities- DOY) may refuse to issue necessary documentation for the transfer of assets if directors are found guilty of tax evasion and may allow confidential information about their financial condition to be disclosed.[99]

6.2.2 Commercial Law violations

- Competition Law: According to Article 44 para 1 of L. 3959/2011 there is a recurrent fine on directors of public companies for any prohibited transaction or for coercive practices etc.[100]

[94] See, - Art. 22 paragraphs 4,5,7,8 and 10 of L. 2523/1997; Art. 46 of L. 2065/1992; L. 1867/1989.
[95] Art. 115 of L. 2238/1994 (income tax); Art. 45 of L. 1642/1986 (VAT); Art. 22 para 7 of L. 2648/1998 (turnover tax- FKE); Art. 25 para 1 of L. 1676/1986 (FSK).
[96] Art. 27 of L. 1992/1990; Decision of the Minister of Economy and Finance (AYO) 2036208/5243-17/0016/1990.
[97] Article 25 of L. 1882/1990; Art. 34 of L. 3220/2004.
[98] See, Art. 17, 18, 19, 20 and 23 of L. 2529/1997.
[99] See, Art. 14 of L. 2523/1997.
[100] See Art. 29 and 30 of L. 703/77 See new law 3959/2011!

- Commercial confidentiality: If a director of a company discloses the company's confidential information to third parties in order to help competitors or intending to harm the company, then the director faces up to six months of imprisonment and financial sanctions[101].
- Pursuant to art. 176 of Law 3588/2007 (Bankruptcy Code) directors have criminal liability for certain offences they committed in their official capacity to the detriment of the company's creditors.

6.2.3 Capital markets law violations

Under art. 10 of L. 3016/2004 all members of the board of directors who do not abide by the duties imposed by this statute may be held liable for breach of duties and in that case, the Capital Markets Commission may impose sanctions under art. 1 para 4(b) of L. 2836/2000. In addition, the Commission is quite strict regarding market abusive behaviours, for example if a director discloses misleading or inaccurate information he will be fined by the Commission.[102] Moreover, with reference to the issue of inside trading for listed companies, members of the board of directors, as well as directors (non-members of the Bod), are not allowed to acquire or sell securities of the company in which they are members of the BoD or directors if their acts are based on information they received in the course of their duties. L. 3340/2005 addresses this issues by imposing a minimum sentence of three months of imprisonment and a fine for breach of this obligation. Finally, Articles 8 and 9 of the Decision of the Capital Markets Commission 5/204/2000 set out a number of sanctions against certain transactions between directors and members of the board.

[101] See, Art. 16 and 18 of L. 146/1914.
[102] See, articles 47 para 4, 72 para 2 and 76 para 8 of L. 1969/91, as well as 34 of L. 3632/1928.

7 CONFLICT OF LAWS

7.1 Classification under Greek private international law

In Greek law, art. 10 of the Civil Code states that, “the capacity of the legal entity is regulated by the law of its seat.”[103] Under this scope, legal commentators and the Greek courts hold to the real seat recognition theory. This rule knows three exceptions: companies established in other EU member countries,[104] maritime companies[105] and companies established in the United States of America[106] and some other jurisdictions.

7.1.1 Company law

Lex societatis is the law governing the rights and duties of shareholders, especially in reference with the right to receive a dividend, voting rights etc. In the case of an extra- “statutory shareholders’ agreement” though, *lex contractus* would be the applicable law. As regards duties and authorised operations of the corporate organs (such as the quorum required for certain decisions, the election of organs, the internal relations of the company (internal structure etc.), these are issues governed by *lex societatis*.

As it is aforementioned, directors provide independent services, unless they perform additional tasks under a separate services contract. The duties of directors are governed by the *lex societatis*. Nevertheless, an independent contractual relationship between a director and the company is governed by the *lex contractus*. At this point it should be mentioned that Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) excludes from its scope *“questions governed by the law of companies and other bodies, corporate or unincorporated, such as the creation, by registration or otherwise, legal capacity, internal organisation or winding-up of companies and other bodies, corporate or unincorporated, and the personal liability of officers and members as such for the obligations of the company or body.”*

7.1.2 Groups of companies

In the case of a group of companies, the general rule is the application of the *lex societatis* for every one legal entity individually for all issues relating to the company. For example, in the case of participation of a member of the board of directors of an English parent company to a competitive

[103] In their “Explanation of the Civil code”, Georgiades and Stathopoulos, commenting on art. 10, state, “The formation of the legal entity is to be regulated by the law of its seat (Athens Court of Appeal 2701/1968). Even if the type of company is unknown to Greek law, this does not affect the acknowledgement of the legal personality within Greece.”
[104] See, Centros Ltd v Erhversus-og Selkabssyrelsen (1999) C-212/97; Überseering BV v Nordic Construction Company Baumanagement GmbH (2002) C-208/00.
[105] See, Art. 1 of L. 791/1978 where it is stated that if a foreign company is owing or chartering ships under Greek flag then the governing law is the law of the state where they were incorporated and not where they have their real seat (see, Art. 25 L. 27/1975 and Necessity Law 89/1967 and 378/1967; see, Supreme Court decision 796/1993 DEE 1995, p. 281.
[106] See, Greece–US Convention of 3 August 1951, on 'Friendship, Commerce and Navigation' (Law No. 2893/1954). Pursuant to Art. 24 para 3 the law of the State of incorporation is considered to be the *lex societatis.*

transaction with its Greek subsidiary, which under art. 23a of L. 2190/1920 would be prohibited for a Greek directors, could be valid as long as the English law does not include such prohibition.

7.1.3 Tort law

The question of which acts lead to a public company's liability based on tort law is governed by the *lex loci delicti*. In other words, the question of a shareholder's claim against the company or a third person for losses suffered due to the directors' tortious acts is regulated by the rules applicable to the tortious act, which under Article 26 of the Civil Code is the place where the tortious act was committed[107] (*lex loci delicti commissi*), a rule that applies in all tort claims.

As a practical matter, pursuant to Article 2, para 2 (d) of the Rome II Regulation (Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007) "non-contractual obligations arising out of the law of companies and other bodies corporate or unincorporated regarding matters such as the creation, by registration or otherwise, legal capacity, internal organisation or winding-up of companies and other bodies corporate or unincorporated, the personal liability of officers and members as such for the obligations of the company or body and the personal liability of auditors to a company or to its members in the statutory audits of accounting documents" are excluded from the scope of the Regulation. Hence, the Regulation Rome II is not applicable in this case.

7.1.4 Special duties in the vicinity of insolvency

Under private international law rules, the *lex causae* of this relationship, i.e. *lex societatis* will determine the governing law even in the occurrence of the company's insolvency. In any event, it is possible that certain public law provisions articulated in the Insolvency Code, could be considered as public policy rules, meaning that in the Greek *forum* these provisions would be applicable even if the contractual relationship between the director and the company is governed by different law. The question of whether a provision is deemed a public policy rule («*ordre public*») is a question that can only be answered by the courts.

It is worth noting that in the event of insolvency proceedings the general rule of *lex fori concursus* applies, and the connecting factor is the "centre of main interest" (art. 4 para 1 of the Insolvency Code). Regulation 1346/2000 is the governing law for such proceedings, and pursuant to its mandates the courts of the Member State where the company has its "centre of main interest" has jurisdiction. Under recital 13 the "centre of main interest" (COMI) refers to the "place of the management". According to art. 3 para 1 (a), the COMI is presumed to be at the place of incorporation. This is, however, a rebuttable presumption. Nevertheless, the scope of the regulation only governs collective proceedings in the event of insolvency; while this means that the general duties are not governed by the law of the COMI, but rather by the jurisdiction of incorporation, the matters governed by art. 98 of the Bankruptcy Code would fall under the regulation, and hence be governed by the lex fori concursus.

[107] See, Pampoukis Ch., Legal persons, p. 151; Supreme Court 949/1990, EEmpD 1991, p. 318.

7.2 Application of the relevant private international law rule

In a case back in 1987, the Athens Court of Appeals had accepted in its judgement that foreign nationals who were directors of a foreign insurance company, as its lawful representatives, were liable to the company extending the Greek approach of directors' liability to foreign companies.[108] This position has of course been overruled by the jurisprudence of the ECJ, effectively resulting in the application of the incorporation state law.[109]

The existence of two different theories regarding the identification of the company's seat, that of the incorporation and the real seat doctrine, raises significant issues with reference to the law applicable. For example, if the real seat of a company is in Greece but it is incorporated under the law of another country (that recognises the incorporation theory), under Greek law this company is governed by the Greek law. However, since this company was not established under the provisions set out in Law 2190/1920 (art. 4 para 1 in conjunction with art. 7a para 1(a) and 7b para 10) and is not registered in the official registry for the public companies, it cannot be treated as such under Greek law. As a result, in the past courts used to treat foreign companies established in Greece as a "de facto" general partnership (αδημοσίευση εν τοις πράγμασι ομόρρυθμη εταιρία). In any case, the courts did not consider personally liable the sole partner in such a company.[110]

[108] See, Athens Court of Appeals 7221/86 ElIDni 1987, p. 140.

[109] See ECJ Case C-212/97, *Centros Ltd. and Erhvervs- og Selskabsstyrelsen*, [1999] ECR I-1459; Case 208/00, *Überseering BV and Nordic Construction Company Baumanagement (NCC)* [2002] ECR I-9919; Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam and Inspire Art Ltd.* [2003] I-10155.

[110] See, Supreme Court decision 1177/1999, NOMOS; Supreme Court decision 812/2008, Nomos.

DIRECTORS' DUTIES AND LIABILITY IN HUNGARY

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Contents

1 INTRODUCTION

1.1 Corporate law and directors' duties in Hungary

In the development of Hungarian company law the importance of cultural, social, political, historical factors seems to be inevitable and this may influence the prevailing views and doctrines of regulation. As far as Hungarian company law is concerned, the importance of such factors concerning the duties and liabilities of directors cannot be presented neither on the level of legislation nor in court practice. As far as the general regulatory framework is concerned, the first company act after the transition determining the structure of company law legislation even for today was the Act no. VI of 1988. At that time the primary task of legislation was establishing the regulatory framework for privatisation. The drafters of the Company Act of 1988 went back to the Hungarian commercial law of the period before World War II. In 1875 – as perhaps the most successful product of codification before World War II – the Hungarian Commercial Code was enacted. The Commercial Code was modelled after the German ADHGB and provided regulation of commercial companies together with the Act no. V of 1930 on limited liability companies modelled after the German GmbH-Gesetz as well. This strong impact of German commercial law legislation determined the regulation of commercial companies in the period before World War II and had been preserved as drafters took the Commercial Code of 1875 and the Ltd-Act of 1930 as the basis for regulation of company law in 1988. Thus, Hungarian company law follows the traditions of German company law in general. Although this impact influences the structure of the companies, the view concerning the source of authority (original rather than a delegated one), duties of loyalty and the structure of organs and decision-making system of a company, does not seem to affect directly the rules covering the liability of directors neither seem to have any influence in court practice.

Company law regulation is provided in a separate act in Hungarian private law (Act no IV of 2006 on Companies, further referred to as Company Act 2006). The regulatory background for company law regulation is the Act of 1959 no. IV on Hungarian Civil Code (further referred to as Civil Code). The provisions of the Civil Code shall be applied in respect of the financial and personal relations of companies and their members (shareholders) not regulated by the Company Act. There is no corporate code either as statutory regulation or as soft law that should be applied for duties and liability of the directors of companies. The Bill of a new Hungarian Civil Code[1] has been submitted to the Hungarian Parliament in the June of 2012 and is to be passed in December of 2012. According to the announced plans the new Civil Code (further referred to as New Civil Code) shall come into effect by 1st January 2014. The structure of company law regulation is to be changed by the New Civil Code as the regime of separate legislation will not be maintained and the company law regulation will be incorporated in the New Civil Code. This does not necessarily bring significant changes in substance of law neither on level of structure, nor concerning detailed rules. Directors' duties and liabilities are embedded in tort law and will be amended by specific rules of company law. Hungarian law assumes a contractual relationship between the company and its directors/general managers, and duties and liabilities of directors are provided in a multi-layered structure, covered by:

[1] http://www.parlament.hu/internet/plsql/ogy_irom.irom_adat?p_ckl=39&p_izon=7971

1. Specific rules provided by company law regulation, as the most specific level, which refer, as a background, to general norms of private law;[2]
2. Rules providing the liability for breach of contract as a more general level, which refer back to general rules of tort law; and
3. General rules of tort law providing the most general background of directors' duties and liabilities

The basis of liability of directors in Hungarian law for incompliance with their statutory and fiduciary duties is the fault based liability regime provided in Hungarian Civil Code. Directors shall be liable for any losses caused by incompliance with the law, breach of the memorandum of association, resolutions of the company's supreme body, or their management obligations to the company according to the general rules of civil law liability.

Directors of the company shall conduct the management of the company with due care and diligence as generally expected from persons in such positions and - unless otherwise provided in the Company Act – they shall give priority to the interests of the company.[3] The priority directors are required to follow changes if the company comes to the verge of insolvency. In case of imminent threat of insolvency, directors shall conduct the management of the company with giving priority to the company's creditors (instead of the company). In case of non-compliance with this obligation and if the company is deemed to be insolvent, the directors affected may be subject to liability under a specific regime vis-á-vis the company's creditors[4] provided by bankruptcy law.[5]

The memorandum of association may contain provisions for the company's supreme body to evaluate on an annual basis the work of the directors in the previous financial year, and to decide concerning the granting of any discharge of liability to certain executive officers. Granting a discharge of liability constitutes the supreme body's verification that the directors in question have performed their duties during the covered period by giving priority to the interests of the company. The discharge of liability shall be abolished in the event of a subsequent court ruling declaring the information based on which the discharge of liability was granted false or insufficient.[6]

If directors are vested with joint right of representation or where the company is managed by a body, the liability of executive officers for damages to the company shall be joint and several according to the provisions of the Civil Code pertaining to joint negligence. If the damage results from a decision of the management body, any member who did not take part in the decision-making process or voted against it shall be exempt from liability.[7]

The fault based liability for damages provided by the Hungarian Civil Code is covered with the general rule of liability, which establishes that persons causing damage to others are to be liable for such damages and they shall be relieved of liability if they proved that they acted as it was under the given circumstances generally expected.[8] The specific standard of required standard of conduct for directors

[2] § 30 subpar (2) of Company Act 2006
[3] § 30 Subpar 2 of the Act no. IV of 2006, further referred to as Company Act
[4] § 30 Subpar 3 of Company Act
[5] § 33/A subpar 1. of Act no. XLIX of 1991 on Bankruptcy Proceedings and Liquidation Proceedings (further referred to as Bankruptcy Act 1991).
[6] § 30 Subpar 5 of Company Act
[7] § 30 Subpar 4 of Company Act
[8] This is a very flexible system of liability based on a reversed burden of proof in so far as fault is concerned ((§ 339 of Hungarian Civil Code)

is provided with the due care and diligence as generally expected from persons in such positions and giving priority to the interests of the company (unless otherwise provided in the Company Act). There are some specific duties provided in statutory legislation esp. in the Company Act covering the shareholders' right to get information, registering the changes in ownership of shares etc. but they don't result in specific regime of liability.

The system of directors' liability is anchored in the general rules of civil law liability which, as they stand now, follow a unitary system covering contractual and delictual liability regime as well.[9] This unitary system will be changed with the New Civil Code which introduces a limitation of liability for breach of contract to the losses that were foreseeable at the time of contracting. According to this rule, as a consequence of breach of contract, the damage occurred in the patrimony of the party and his lost profits are to be compensated to the extent as it was foreseeable as the potential consequence of breach at the time of concluding the contract. The burden of proof that the loss as a potential consequence of breach of contract was foreseeable at the time of contracting rests on the plaintiff[10] (in context of liability of directors, on the company). The applicability of the foreseeability limit does not necessarily bring significant changes in the risks allocated to the directors. Courts will presumably tend to assume that at the time of accepting the position the director foresaw all the potential risks involved in the position.

Failure of compliance with the requirement of following the priority interests of creditors is covered by bankruptcy law. There are no other specific areas of law establishing liability regimes for directors.

1.2 Corporate landscape in Hungary

1.2.1 Company types in Hungary and ownership structure

Hungarian company law rests on a *numerus clausus* of forms of companies. This means that legislation provides for the typos of companies and partnerships that may be incorporated and investors or founders are not free in creating new types or mix the provided ones.

The following types of company exist under Hungarian law:

- *Public limited company* (*részvénytársaság*) is a company founded with a share capital (subscribed capital) consisting of shares of a pre-determined number and face value, in the case of which the obligation of members (shareholders) to the public limited company extends to the provision of the face value or the issue price of shares. Shareholders normally shall not be liable for the debts of a public limited company. The shares are either listed (*nyilvánosan működő részvénytársaság*, Nyrt) or not listed (*zártkörűen működő részvénytársaság*, Zrt) at the stock market.
- *Private limited company* (*korlátolt felelősségű társaság*, Kft) is a company, founded with a subscribed capital, consisting of capital contributions of a pre-determined amount, in the case of which the liability of members to the company extends only to the provision of their capital contributions, and to other possible contributions as set forth in the memorandum of association. Members normally shall not be liable for the debts of the company.

[9] § 318 of Hungarian Civil Code
[10] § 6:143 of New Civil Code

- *Limited partnership* (*betéti társaság* Bt), where the liability of at least one member (general partner) for the obligations not covered by the assets of the partnership is unlimited, and is joint and several with all other general partners, while at least one other member (limited partner) is only obliged to provide the capital contribution undertaken in the memorandum of association, and normally is not liable for the obligations of the partnership.
- *General partnership* (*közkereseti társaság*, Kkt), where the members of the partnership are joint and severally liable for the debts of the partnership.

The most general type of company is the private limited company. Partnerships are typical for family enterprises, although there are a few huge enterprises (even branches of multinational companies) established in a form of general partnership as well. The distinction between listed and non-listed companies is a relatively recent development. There are only a few significant differences on the level of company law regulation for listed and non-listed PLCs, the most important may be that where the articles of association of a listed public limited company so provides, it shall be controlled by the board of directors under the one-tier system instead of the management board and the supervisory board. In this case, the board of directors shall discharge the duties of the management board and the supervisory board conferred upon them by law

1.2.2 Standards applicable depending on the type of company

In the structure of regulation the main distinctions between the accepted forms of companies are shaped according to:

- Liability of members (shareholders) for the debts of the company
- Transferability of shares
- If the company offered the shares for sale to the public or not

In the forms of companies with limited liability (PLC, private limited company, limited partnership) the liability of the member (shareholder) for the debts of the company is limited to the assets he acquired from the company's patrimony if the company was liquidated. There are some exceptions where members (shareholders) are made liable for the debts of the company, such as abuse of limited liability, liability for the debts of the controlled company in group of companies, or tendentious detrimental business policy implemented in controlled company.

The position of the management is provided among the general provisions of the Company Act 2006 and among the general provisions covering management of legal entities of the New Hungarian Civil Code. The regulation provides standards and only a few specific rules. The regulation concerning the liability of directors goes back and is rested on the general tort law (more precisely, the liability for breach of contract). The idea of the Hungarian legislator was that the flexible system of civil law liability provides enough playing field for the courts in assessing each of the cases. The Hungarian tort law regulation is a system of open rules. These open rules allow great power to the courts and let them establish and apply the proper guidelines to assess the tort law cases. As a result of this system a great part of the Hungarian tort law is a judge-made law, which applies a complex system of criteria to assess and decide tort law cases and to draw the boundaries of liability. The Hungarian tort law as a law in action is a flexible system[11] where the decision of the court is a result of weighing different elements in each of the tort law cases. In this system the two main measures of limitation of liability for the court practice are the concept of accountability as the basis of liability and the causation. That holds for liability of directors as well. Concerning liability of directors, there are no specific rules provided for the management of different types of company.

There are specific rules covering the utilization of the property of the state and of the local municipalities as well as the transactions concerning the assets belonging to them[12] but this does not establish specific regime for duties and liabilities of directors.

The shaping of directors duties and liabilities are in this system basically left to court practice in Hungarian law. There is still a relatively poor reported case law, where the courts mostly restrict themselves to establish more or less obvious guidelines. What role of market practices play in establishing duties and liabilities of directors is not clear in relevant case law.

In other areas of professional liability (esp. in medical malpractice) courts tending to regard best practices or settled protocols and requirements as the part of the required standard of conduct which are to be followed by professionals but they cannot be relieved of liability solely by referring to that they complied with them. Thus, courts may require and establish stricter or further standards for the given scenario.

1.3 The board of a Hungarian company

The management of public limited companies shall be conducted by the board of directors, except where the powers of the management board are conferred under articles of association of public limited companies upon a single executive officer (general director). The articles of association of public limited companies registered at the stock market may also contain provisions to tender management and supervisory functions upon a board of directors (one-tier system). Such a public limited company shall have no supervisory board, and the members of the board of directors shall be treated as executive officers.

According to regulation provided in Company Act 2006, the board of directors consists of minimum three and maximum eleven members, all natural persons. The management body shall elect its chairman from among its members. The articles of association may prescribe that the chairman of the management board be elected directly by the general meeting. The board of directors shall exercise its rights and perform its duties as an independent body. The rules of procedure approved by the board shall provide for the division of tasks and competence among the members of the board of directors.[13] The New Civil Code provides for that board of directors consists of three natural persons and establishes that directors are passing decisions and perform their duties as a board, but does not establish that it is an independent body.[14]

[11] Really as it has been established by *Walter Wilburg*. See: Walter Wilburg: Entwicklung eines beweglichen Systems im Bürgerlichen Recht (Rede gehalten bei der Inauguration als Rector magnificus der Karl-Franzes Universität in Graz am 22 November 1950, Graz, um 1950.) and Zusammenspiel der Kräfte im Aufbau des Schuldrechts [163 AcP (1964) pp. 364. et seq.
[12] Act no. CXCVI. of 2011. on public property
[13] § 243 subpar (1) and (2)
[14] § 3:265

Companies registered at the stock-market may opt for a one-tier system. Under a one-tier system, the board of directors shall discharge the duties of the management board and the supervisory board conferred upon them by law. The board of directors in the one-tier system shall consist of minimum five and maximum eleven members, all natural persons, unless the articles of association provides otherwise with a view to employee participation. The board of directors shall elect its chairman from among its members. The articles of association may prescribe that the chairman of the board of directors be elected directly by the general meeting.

The majority of the board of directors shall be made up of independent persons, unless the articles of association prescribe a higher percentage. A board member shall be considered independent if holding an office only on the board of directors of the public limited company.

A board member shall not be considered independent, in particular, if:

a) An employee of the public limited company, or if a former employee for five years following the termination of such employment;

b) Providing services to the public limited company or its executive officers for consideration as an expert or other similar services;

c) A shareholder of the public limited company controlling at least thirty per cent of the votes, whether directly or indirectly, or is a close relative [Civil Code, Paragraph b) of Section 685] or a domestic spouse of such person;

d) A close relative of any - non-independent - executive officer or executive employee of the public limited company;

e) Entitled to receive financial benefits based on his board membership if the public limited company operates profitably, or receives any other form of remuneration from the company apart from the salary for his board membership, or from a company that is affiliated to the public limited company;

f) Engaged in a partnership with a non-independent member of the public limited company in another company on the strength of which the non-independent members attains control;

g) An independent auditor of the public limited company, or an employee or partner of such auditor, for three years following the termination of such relationship;

h) An executive officer or executive employee of a company, whose independent board member also holds an executive office in the public limited company.

The requirement for the majority of the board of directors to be made up of independent persons shall not apply if the public limited company is a controlled company belonging to a recognised group of companies.[15]

[15] § 310 and 311 of Company Act 2006. The New Civil Code, as it stands now, fixes the number of the members of the board of directors in five natural persons, otherwise maintains the same regulation as it is provided in the Company Act 2006.s

2 CONCEPT OF COMPANY DIRECTOR

2.1 De jure directors

2.1.1 Requirements to become a *de jure* director

Persons that are registered by the Court of Registry as general managers (directors) of the company are to be held as directors and directors' duties and liabilities are imposed on these persons.

The control or influence on the decisions and conduct of directors may establish liability only in exceptional cases provided in statutory legislation under circumstances specified as preconditions of such liability. Duties and liabilities of directors *per se* are shifted neither by the courts nor by legislation to shareholders on the basis that they exercised their voting rights in a wrongful manner or to other persons exercising influence on the decision of the company's organs. Thus, duties and liabilities covered by this report apply only to *de jure* directors. The basis of this distinction is that general managers and directors of a company – except the case of a single-member company – cannot be instructed by the shareholders. As it is provided in the Company Act 2006, and maintained in the New Civil Code, directors shall discharge their duties independently and are superseded only by legal regulations, the memorandum of association, and the resolution of the company's supreme body and, subject to the exception set out in the rules covering single-member companies, may not be instructed by the members (shareholders) of the company.[16] In absence of specific statutory legislation, Hungarian court practice does not seem to be open so far to establish liability of persons exercising influence on the decisions of the company neither on the basis of tort law (e.g. by establishing causation via psychological influence or by applying simply the general rules of liability) nor under company law regulation.

The control over the decisions of the company (exercising voting rights or actual influence) may establish liability under the circumstances specified below in this report.

The board of directors shall exercise its rights and perform its duties as an independent body.[17] Although the liability of the members of the board shall be – as liability of multiple tortfeasors – joint and several liability, the liability of the members of the board is to be established individually. Thus, the member of the board shall be relieved of liability either by proving that he complied with the standard of conduct specified for the general managers of the company, or by proving that he did not take part in the decision or voted against it[18] or that the general prerequisites of liability[19] are not to be established against him.

[16] § 22 subpar 4 of Company Act 2006, §3:96 subpar 2 of the New Civil Code.
[17] § 243 subpar 2 of Company Act, New Civil Code § 3:96 subpar 1
[18] § 30 subpar 4 of Company Act; "or by proving that he did not take part in the decision or voted against it" as a basis for getting relieved of liability is not maintained in the New Civil Code. The reason if it could be that if the director did not take part in voting for the decision, there is no causal link to be established between the loss and a wrongful behaviour on his side.
[19] § 339 of Hungarian Civil Code

The New Civil Code, making a division between contractual and non-contractual liability, provides that party causing loss to the other party with a breach of contract shall be obliged to pay damages. The party, breaching the contract shall be relieved of liability if he proved that the breach of contract is a consequence of a cause which was beyond his control, was unforeseeable and avoidance or prevention of it could not be expected from him.[20] As contractual relationship is assumed between the company and the directors, the change in the system of liability of the Civil Code will change the prerequisites of liability to be applied for the directors as well. A further exception is that in case of single-member companies, the sole member (shareholder) may instruct the director in writing, which the executive officer is required to carry out; however, in this case he shall be exempt from the liability imposed on him as a director of the company.[21]

Thus, if liability of members of the board had been established individually, their liability is a joint and several one *vis-á-vis* the company.

2.1.2 Who can be a de jure director?

Only a natural person can be director of the company (either as a member of the board or as a general director).[22] There is no explicit limit of age but from the general provisions of the Civil Code it is obvious that minors cannot be appointed as directors or general managers of the company.

There are persons who are prevented from being appointed as a director of the company:

- A person who has been sentenced to imprisonment by final verdict for committing of a crime may not be a director of the company until relieved from the detrimental legal consequences related to his criminal record;

- Any person who has been banned by a standing court verdict from accepting an executive office may not be appointed as a director under the duration of such ban;

- Any person who has been restrained by a standing court verdict from any profession may not serve as an executive officer in a company whose main business activity covers such profession;

- For a period of five years after the removal of a company from the register of companies based on winding-up proceedings, any person who, at the time of the opening of the winding-up proceedings, during the year when such removal took place or during the previous year served as an executive officer of the terminated company or held a share embodying exclusive or majority control, may not be an executive officer of another company;

- Any person whose liability - in his capacity as the executive officer of an economic operator terminated without succession or the member (shareholder) of such economic operator with exclusive or majority control - for any claims that remain unsatisfied in proceedings resulting in termination without succession has been declared by final court decision in accordance with the Bankruptcy Act or the Companies' Registration Act and who failed to discharge the payment obligations in compliance with the guarantee obligation contained in the final court decision may not be an executive officer of another company;

- Any person upon whom the court of registry has imposed a financial penalty in the course of judicial oversight proceedings, and who failed to comply with the payment obligation set out in the final court decision, may not be an executive officer of a company; and

[20] New Civil Code § 6: 142

[21] § 22 subpar 5 of Company Act. Not provided in the New Civil Code but it is still a necessary consequence as in such cases there is no wrongful conduct to be liable for on behalf of the director.

[22] § 22 subpar 1 of Company Act

- Any person who failed to comply with the guarantee obligation set out in Subsection (1) of Section 104 of the Company Act may not be an executive officer of a company.[23]

In its core content, the New Civil Code will maintain this list of circumstances preventing persons from being appointed as a director of a company[24]

2.2 De facto directors

Directors' duties and liabilities are imposed on persons who are formally appointed as director of the company. Court practice does not extend the concept of director to or impose the director's duties and liabilities on other persons. Other persons may be liable on the basis of exercising voting rights or influencing the operation or decisions of the company under explicit statutory provisions specified below. In Hungarian company law duties and liabilities of directors are not directly extended to persons exercising influence on the operation or decisions of the company. There are, however, some specific statutory liability regimes under which such persons may be held liable *vis-á-vis* the creditors of the company in case of the company's insolvency on the basis of the influence they exercised on the operation or decisions of the company.

<u>Liability of majority shareholders.</u> If shareholders holding a qualifying majority follow a business policy permanently detrimental to the company and as the result of this business policy the company is grossly jeopardized in performing its obligations, the competent court of registry may - at the request of any creditor of the controlled company - instruct the shareholder having a qualified majority of shares to provide collateral security, or may impose the judicial supervisory sanctions specified in the Company Registry Act upon him. If the controlled company is going into liquidation, the owner of a qualifying holding shall bear unlimited liability for all liabilities of the company for which the debtor controlled company is lacking sufficient cover in the process of liquidation proceedings, if the court has declared - in an action filed by the creditors during the liquidation proceedings - the unlimited and full liability of the owner of a qualifying holding responsible due to its history of making unfavourable business decisions in the debtor company.[25]

<u>Liability of shadow directors.</u> Shadow directors are not specifically defined under Hungarian law. They are mentioned in the Bankruptcy Act in context of their liability for a breach of the obligation to manage a company threatened with insolvency in accordance with the concept of the obligation to prioritise the creditors' interests. Therefore, the concept of shadow directors is interpreted in the context of this obligation and understood to cover persons who have actually had a dominant influence on the company's decision-making processes.

Any creditor or the liquidator - in the debtor's name - may bring an action during the liquidation proceedings before the court to establish that the former executives of the economic operator failed to properly represent the preferential rights of creditors in the span of three years prior to the opening of liquidation proceedings in the wake of any situation carrying potential danger of insolvency, in consequence of which the economic operator's assets have diminished, or that they prevented to provide full satisfaction for the creditors' claims, or failed to carry out the cleaning up of environmental

[23] § 23 of Company Act 2006
[24] § 3:19 and § 3:99 of the New Civil Code. Maybe subject to change in the parliamentary phase.
[25] § 54 of Company Act, § 3:303 of New Civil Code

damages. If damage is caused by several persons together their liability shall be joint and several. A situation is considered to carry potential danger of insolvency as of the day when the executives of the economic operator were or should have been able to foresee that the economic operator will not be able to satisfy its liabilities when due.

In the aforesaid court action, financial security may also be demanded with a view to providing satisfaction for the creditors' claims. This security may be provided in the form of money deposited with the administration office of the court and held in a deposit account, or liquid assets tied up in a credit institution and held in a discretionary account (cash deposit), or debt securities issued or guaranteed by the government of any EEA Member State or by any credit institution with a remaining maturity of more than one hundred and eighty days that can be redeemed or liquidated on demand, or a bank guarantee, insurance guarantee or a commitment issued by an insurance company containing surety facilities. Provision of the financial security as established by the court shall be guaranteed by the member (shareholder) holding majority control [Civil Code, Section 685/B] in the debtor economic operator (or by the member in the case of single-member companies, the owner in the case of sole proprietorships, or the non-resident owners of Hungarian branches). Non-resident companies may not satisfy their payment obligation arising from the said guarantee from the assets made available to the branch. Under the application of this rule, *any person with powers to influence the decision-making mechanisms of the economic operator* shall also be considered an executive of the economic operator.[26]

<u>Recognised or actual group of companies.</u> The shareholder controlling the controlled company in a recognised or actual group of companies shall remain liable for the obligations undertaken during the existence of the recognized group of companies also after the group ceases to exist.[27][28]

If, under the regulation provided by the Company Act,[29] a recognised group of companies had been established, the director of the controlled company shall conduct - in accordance with the control contract - the management of the company by giving priority to the interests of the recognised group as a whole. The executive officer shall be exempt from the provisions covering the liability of directors if his conduct is found to be in compliance with the relevant provisions set out in legal regulation and in the control contract.[30]

[26] § 33/A subpars 1. and 5 of Bankruptcy Act.
[27] § 63 subpar 3 of Company Act. For the concept of recognised and actual group of companies see below.
[28] According to § 3: 371 of the New Civil Code, the controlling company shall not be liable if it proved that insolvency was not the consequence of the common business policy.
[29] Any companies being required to draw up consolidated annual reports according to the Accounting Act (dominant member) and any public or private limited company, or private limited-liability company over which the dominant member effectively exercises a dominant influence according to the Accounting Act (controlled company) may decide to enter into a control contract to join forces in pursuing their common business interests and continue operating in the form of a recognized group. § 55 subpar 1. of Company Act. These provisions may be applied in the absence of a control contract and registration as a recognized group, if the companies belonging to the group are engaged in operations under a common business strategy for at least three consecutive years based on collaboration between the dominant member and the controlled company (companies), and they demonstrate the kind of conduct to ensure the predictability and balanced allocation of the advantages and disadvantages stemming from operating in the form of a group (actual group of companies. § 64 subpar 1 of Company Act. The system in its substance maintained in the New Civil code
[30] Maintained in the New Civil Code see § 3:367 subpar 4.

3 SCOPE OF DIRECTORS' DUTIES UNDER HUNGARIAN LAW

3.1 Types of directors' duties

3.1.1 Where regulated?

The legal relationship between the company and the director is necessarily of a fiduciary nature. The rights and obligations of executive officers in this capacity shall be governed, with the exceptions set out by statutory provisions by the provisions of the Civil Code relating to personal service contracts (company law), or by the employment regulations (as a labour law relationship).[31] Although not expressed or explicitly manifested, the basic policy behind establishing the duties and liabilities of directors is reducing agency costs in the principal-agent relationship between the company (or creditors of the company) as principal and the director as agent. The law has to establish methods of deploying substantive law to protect principals (the company or the creditors in Hungarian company law) and to make them less vulnerable to their agents' (the directors) opportunism. One of the main characteristics of modern companies is separating ownership and control (management) resulting in the principal-agent relationship. Thus, the main policy justification is setting up the structure of optimal incentives in order to prevent directors from behaving opportunistically (i.e. following his own interests in conflict of interests) and internalising the costs of their decisions.[32]

Such justifications do not seem to have any effect on practical implementation or interpretation of the relevant rules so far. The reason of this can be that there is a relatively poor accessible case law covering the problems of liability of directors in Hungary.

Duties and liabilities of directors are defined, although with general standards, on the level of company law and – in case of liability *vis-á-vis* the creditors in case of failure of compliance with the requirement of prioritising the creditors' interests – in bankruptcy law. As, however, liability of directors is embedded in tort law also provided by explicit provisions in the Company Act, duties and liabilities are considered under company law (and tort law) and consequences of incompliance with such duties are considered under tort law. There are certain crimes that may be committed by executive officers of the company but they are not directly related to fiduciary duties imposed on directors.

As it has been mentioned above, the case law concerning the liability of directors is poor in Hungarian court practice. There are very few reported cases and from the reported decisions one cannot draw more abstract or far reaching consequences. The reason of this may be that that there are few cases brought to the courts, that reported decisions involve obvious cases where the decision does not require further justification, and also that courts abstain from formulating generalised or abstract conclusions or establishing guidelines, tests, examples of proper assessment of cases etc.

[31] § 22 subpar 2 of Company Act, New Civil Code § 3: 96 subpar 1
[32] KISFALUDI András/BODOR Mária/GÁL Judit/PETHŐNÉ KOVÁCS Ágnes, SZEGEDINÉ SEBESTYÉN Katalin/SIMON István, A gazdasági társaságok nagy kézikönyve. 2007, Budapest, Complex Meritum. p. 363.

3.1.2 Directors must act according to the priority of the interests of the company

Although some of the duties of directors are explicitly provided by the law (like rules covering certain cases of conflicts of interests, non-disclosure of business secrets etc.), at the centre of their primary duty is loyalty to the company. The main element of this duty is the requirement of following the priority of the interests of the company and acting according to the standard of conduct generally required from persons holding such positions provided in company law legislation. In Hungarian company law there are two major duty imposed on directors: duty of care and duty of loyalty.

Thus, Hungarian law defines the duties of directors much more with broad and flexible standards than providing detailed rules or precisely formulated requirements. Neither in court practice are such requirements precisely settled. As the priority to be followed is the interests of the company and not of the shareholders, the Hungarian law implies that the authority of the directors follows from the law and directors are to be seen not as the agents of the shareholders but as agents of the company. That is not a decision making power delegated by the shareholders but one imposed on directors by law. Directors owe their duties vis-á-vis the company (not towards shareholders) and – in case the company comes to the verge of insolvency – they owe their duty vis-á-vis the creditors of the company.[33]

Above the generally required standard of conduct and requirement of giving priority to the interests of the company there are some specific duties expressing the requirement of loyalty as well.

Directors shall be responsible for notifying the court of registry concerning the foundation of the company any amendment of the memorandum of association, the rights, facts and data contained in the register of companies and changes therein, as well as any other data required by law. Directors shall bear joint and several liability vis-á-vis the company for any damage resulting from the incorrectness of the data, rights or facts notified, or from any delay in filing or failure to file the notification, including where the annual report prescribed in the Accounting Act and the relating business report is drawn up and published not in compliance with the relevant provisions of the Accounting Act.[34]

Directors shall keep all business secrets of the company as strictly confidential.[35]

Directors shall, with simultaneous notice to the supervisory board, call a general meeting within a period of eight days in order to provide for the necessary measures whenever it comes to its notice that:

a) The company's equity capital has dropped to two-thirds of the share capital due to losses;

b) The equity of the company has dropped below the minimum limit in the Company Act; or

c) The company is on the verge of insolvency or has stopped making payments and its assets do not cover its debts.[36]

[33] See also § 3 :96 subpar 2 and § 3:21 of the New Civil Code
[34] § 26 of Company Act 2006
[35] § 27 subpar 1 of Company Act 2006
[36] § 245 subpar 1 of Company Act 2006

Duties of directors as established in legislation are not conflicting ones. They are rather to be seen as specific formulations of the general duties of loyalty and duty of care. Thus, they are imposed on directors cumulative in so far as directors are required to meet each of them permanently. The general remedy if directors failed to comply with any of their duties imposed on them either by general standards or by explicit statutory provisions is damages. As in Hungarian law the same rules are to be applied for damages for breach of contract and damages in tort,[37] courts normally do not address the question whether the basis of liability is tort or breach of contract. This approach will have to be changed in the regime to be established by the New Civil Code which makes a clear distinction between liability in tort and liability for breach of contract. This distinction will have relevance concerning the exoneration from liability (which will be stricter) and introducing a foreseeability limit for liability for breach of contract. Otherwise the tort law regime is to apply for liability for breach of contract as well. Liability of directors will fall under the regime of liability for breach of contract.[38]

Damages, however, do not seem to provide a proper remedy in cases where directors breached their duty of loyalty with exploiting a profit making opportunity (e.g. making a transaction in their own name for their own profit) owed to the company for themselves. In such cases, as an alternative remedy, the company may claim transferring the profit as an unjust enrichment.[39]

A clear priority concerning the basic duty of loyalty is provided by the legislator. Directors shall follow the interests of the company (either in conflicts of their own interests with the company's ones or the company's interests with the shareholders' one, or the company's interests with the employees' ones etc.). If the company comes to the verge of insolvency, directors are required to follow the interests of the creditors, either in conflicts of the interests of the company with the creditors' ones, either in conflicts of their own interests with the creditors' ones or the creditors' interests with the shareholders' one, or the creditors' interests with the employees' ones etc. Incompliance with this duty shall result in liability of the directors *vis-á-vis* the creditors (wrongful trading)[40] under the regime provided in the Bankruptcy Act in case the company became insolvent and its assets were not enough to cover the claims of creditors.

Another priority of loyalty is provided concerning the duty of disclosure. As a general rule, directors shall, unless it is otherwise provided by law, upon request by the shareholders, provide information concerning the affairs of the company, and allow inspection of its books and documents. In the event of any director's failure to comply with such request, upon request of the shareholder, the court of registry may instruct the company to provide the information in question and/or to provide for inspection. Exercising this right of the shareholders may not infringe upon the business interests or business secrets of the company.[41]

Otherwise it is not necessary to set up priorities between the duties imposed on directors as they are non-conflicting ones.

As duties of directors are structured in the legislation primarily on the basis of broad standards the legislator does not seem to consider the possibility of having conflicts between the duties imposed on

[37] § 318 of Civil Code
[38] § 3:21 of New Civil Code
[39] § 361 et seq. of Civil Code
[40] CSEH Tamás, Új hitelezővédelmi rendelkezés a magyar társasági törvényben és annak elméleti alapjai (wrongful trading). In Jogi tanulmányok, 2006. ELTE Budapest, pp. 7-25.
[41] § 27 subpars 2 and 3 of Company Act 2006.

directors. There is no rule provided for cases of conflicting duties and the courts practice did not provide any guidelines for addressing conflicting duties and dissolving the conflicts.

The liability of directors is anchored in the liability system provided in the Civil Code. In this system liability is a fault-based one rather than a strict liability but rests on reversed burden of proof. Thus, in case the company claims damages from its director and proved the compensable loss and the causal link between the defendant's unlawful behaviour and the loss, it is the defendant (i.e. the director) who can exempt (exonerate) himself by proving that he acted as it was under the given circumstances from a person holding the same position generally. Thus, fault in Hungarian law is an objective concept: failure of acting according to the required standard of conduct itself establishes fault. Compliance with the standard is to be measured to the position held by the director and not to the personal qualities or qualifications of him.

In case of the liability for wrongful training, i.e. if the company came to verge of insolvency and the director is required to act according to the priority of creditors interests, the director shall be relieved by proving that he did all the steps that could be generally required under the given circumstances[42] in order to reduce the loss of the creditors.[43]

3.1.3 Directors must act within their powers

Directors must comply with legal and regulatory provisions applicable to companies and with the company's by-laws.

3.1.4 Directors must avoid conflicts of interest

A director shall not acquire any share - other than shares in public limited companies - in any kind of business organisation whose main business activity is similar to that of the company and may not accept an executive office in a company or cooperative whose main business activity is similar to that of the company, with the exception if so permitted by the memorandum of association of the company affected or if the supreme body of the company has granted its consent. A director and his close relatives or domestic partner may not conclude any transactions falling within the scope of the main activities of the company in his own name and on his own account, unless specifically permitted in the memorandum of association. The director and his close relatives or domestic partner may not be elected as a member of the supervisory board at the same company.[44]

3.1.5 Directors owe a duty of loyalty not to the shareholders but to the company

In Hungarian company law directors' duties are owed to the company or, if the company comes to the vicinity of insolvency, to the creditors but not to the shareholders, as it is explicitly provided in the Company Act.[45] This is supported by the regulation which assumes the legal relationship – either as a

[42] KISFALUDI et al p. 384.
[43] § 33/A subpar. 2 of Bankruptcy Act.
[44] § 25 of Company Act
[45] Directors shall conduct the management of the company with due care and diligence as generally expected from persons in such positions and - unless otherwise provided in the Act - give priority to the interests of the company (§ 30 subpar. 2 of Company Act). In the event of any imminent threat for the company's insolvency, the executive officers shall conduct the management of the company giving priority to the company's creditors (§ 30 subpar. 3 of Company Act).

contract for agency or labour law relationship under employment contract – between the company and the director. Thus, fiduciary duties of the director could not be owed to shareholders.

Assuming that directors' fiduciary duties are owed to the company (or the creditors) but not to shareholders may be a problematic one as the company is certainly established in order to produce profit for the shareholders and it is difficult to establish the company's own interests separated from the interests of other stakeholders. On this ground the approach of the Hungarian legislator can be criticized, but the regulation today is quite clear in this respect. From this follows that it is always the company (or the creditors) that may have a claim against the directors who failed to comply with their fiduciary duties. Even if the right to make the claim is provided to shareholders under minority protection regulation, they enforce the claim in the name of the company (see below).

How the interest of the company are to be identified, including if the duties allow directors to discriminate between different groups of shareholders or make prescriptions how long-term and short-term interests can or should be reconciled was not addressed so far in Hungarian court practice and the legislation does not provide any guidelines for that either.

In very specific cases directors are assumed to have fiduciary duties *vis-á-vis* shareholders, like upon request by the shareholders, directors shall provide information concerning the affairs of the company, and allow inspection of its books and documents. Exercising this right, however, may not infringe upon the business interests or business secrets of the company.[46] In case of calling the general meeting, directors shall provide the necessary information to all shareholders in connection with the items placed on the agenda of the general meeting.[47]

The nature of the company does not affect the fiduciary duties of the directors. Even if the company is a small, family-owned business, directors are assumed to owe their fiduciary duties and liabilities to the company but not to the shareholders. If directors make direct approaches to, and dealing with, the shareholders in relation to a specific transaction and holding themselves out as agents for the shareholders in connection with the acquisition or disposal of shares (like, e.g. by deciding for increase of capital if it is allocated to directors, or disposal of shares owned by the company) directors may owe duties implied by private law to the shareholder but this does not change the priorities to be followed according to company law legislation and which establish that as agent of the company directors owe their fiduciary duties and liabilities to the company and they are not to be exempted or relieved from these duties. This is the case even if directors provide specific information and advice on which the shareholders relied. This, however, does not preclude the shareholder from having a claim *vis-á-vis* the director – for whom the company is to be vicariously liable – on the basis of incompliance with duties owed to him under general private law regulation, principles or doctrines.

[46] § 27 subpars 2 and 3 of Company Act 2006
[47] § 217 subpar 1 of Company Act 2006

3.2 The director as a shareholder

It is not clear in Hungarian law if the director is bound by the fiduciary duties imposed on him in the course of exercising his rights as a shareholder or not. The wording of the regulation establishing the duty of loyalty imposed on directors says that directors (and general managers of companies in general) shall „conduct the management of the company" with due care and diligence as generally expected from persons in such positions and - unless otherwise provided in the Act – they have to do it with giving priority to the interests of the company.[48] The rule certainly does not imply that directors would be subject to directors' duties at all times, also when they do not discharge board functions, but act as shareholders in general meeting. From this follows that the director, exercising his shareholders' rights is not acting as a manager of the company and from this follows that his conduct is not covered with the rules covering the duties and liabilities of the director. Thus, Hungarian company law seems to treat shareholder votes as proprietary rights that the holder may exercise in his or her own interests, even if these interests are opposed to those of the company. As a consequence, the director, in exercising his or her voting rights in general meeting, would not be bound by the directors' duties.

3.3 Begin and end of the duties

Directors are appointed by the shareholders of the company and they have to accept their appointment in order to become the manager of the company.[49] By the time the acceptance becomes effective, the director is in his managerial position in intra-company relationship[50] (he is the one having the rights and whom the duties of the director is imposed on) and as he had been registered by the court of registry, he becomes director *vis-á-vis* third parties as well. Thus, the moment in time at which the duties of the director arise is the acceptance of being appointed as a director. Directors can only be liable for faults committed during their term in office. They are not liable after termination of their directorship. Expiration of directorship terminates the duties imposed on the director but does not relieve the director of consequences of former breach of fiduciary duties. Thus, once the director's liability was triggered by a relevant damaging event, the director's liability does not cease once the directorship expires.

[48] § 30 subpar. 2 of Company Act 2006
[49] § 24 subpar 2 of Company Act 2006
[50] Supreme Cpurt, Legf. Bír. Cgf. II. 32. 478/2001. sz., EBH2002. 780

4 Liability for breach of duty

4.1 Directors' civil liability

Liability of directors is embedded in the general rules of liability for damages. According to the general rule of liability there are four preconditions of liability and if these preconditions are fulfilled, the tortfeasor must pay damages. These four preconditions are:

1. Compensable damage;
2. Unlawful behaviour;
3. Causal link between the unlawful conduct of the tortfeasor and the suffered harm; and
4. Accountability of the tortfeasor's conduct (fault)

Although in Hungarian law – as in other continental legal systems as well – the four preconditions of liability are strictly separated from each other, they are closely interrelated and often are overlapping.

In context of liability of directors of companies *vis-á-vis* the company directors are to be liable if:

- The company suffered a compensable loss (actual loss, lost profit or costs of eliminating or attenuating the loss),
- This loss is in causal link with the conduct of the director,
- This conduct was unlawful, and
- With this conduct the director failed to comply with the required standard of conduct under the given circumstances (fault)

The basis of liability is a breach of a duty imposed on the tortfeasor (in this context on the director) by law. The starting point of Hungarian law is that a conduct causing damage shall be deemed unlawful unless explicitly otherwise provided by the law. Thus, in Hungarian tort law a general duty of not to cause harm to other persons is implied. The basic aim of liability is to prevent the tortfeasor from wrongful behaviour. Thus, in context of directors' liability, the aim of liability is to prevent directors from breaching their duties imposed on them by law and induce them to conduct in compliance with their duties.

Directors shall not be liable if:

- The company did not suffer a compensable damage (the profit their lost would have been illicit, the damage not occurred yet but only threatens, or only a risk has been created etc.),
- There is a compensable loss suffered by the company but it also would have occurred in absence of the director's conduct (there is no causal link between the damage and the director's conduct),

- The director did not commit an unlawful conduct, or
- The director acted as if he was under the given circumstances generally required (i.e. complied with the required standard of conduct).

The director breached his duty if he failed to comply with the duties and obligations imposed on him by law. The director failed to comply with his duties if he failed to comply with duties imposed on him by statutory regulation, the memorandum of association, the resolutions of the company's supreme body, or by his management obligations.[51] The Hungarian tort law – in which liability of directors' is embedded – implies the assumption that causing damage shall be held unlawful if it was not explicitly allowed by the law. From this follows that the fact that the director caused damage establishes the unlawfulness (breach of duty) of his damaging conduct. There is no need to show that a certain legal norm (rule, principle, provision) or the provision of the deed of foundation or resolution of the company had been violated by his behaviour in order to establish breach of duty (unlawful behaviour).[52]

The liability of directors follows the normal fault based liability regime of Hungarian tort law. There does not seem to be any differentiation elaborated like e.g. treating duty of care and breaches of the duty of loyalty as separated elements or preconditions of liability.

The director shall not be liable if he acted according to the required standard of conduct, i.e. if he complied with the requirement of performing his tasks in conduct the management of the company with due care and diligence as generally expected from persons in such positions and - unless otherwise provided by the law - gave priority to the interests of the company.

The required duty of care in Hungarian tort law is an objective measure independent from the personal skills of the tortfeasor. Hungarian courts shall follow objective standards that would require directors to conform to the level of an „ordinary director" in the position of the defendant may be expected to take.

It is not clear at all what the relationship between the required duty of care and the requirement of priority of the company's interests could be. Hungarian court practice does not make a clear distinction between these two requirements as it does not really distinct clearly between the breach of duty and fault as well. It is, however, clear, that courts don't establish liability simply on the ground that the director passed wrong decision making damage to the company. There are only very few reported cases on this sensible and crucial element of liability in Hungarian court practice but one decision may give an insight into the way of thinking of the courts. In this case the director concluded contracts with other partners and undertook the obligation of prepayment for delivery of goods. The goods had never been delivered and pre-payment could not be revoked. The court rejected the claim against the director on the ground that he prepared the transaction with the required duty of care and although it proved to be a wrong decision, it was still in the scope of normal business risks.[53]

Although a clear business judgement rule has not been elaborated or established in Hungarian court practice, courts don't establish liability if the conduct (decision) of the director fell within the frames of normal business risks. Thus, Hungarian courts don't want to shift the risks of business decisions to the directors of the company.[54] If the director failed to take care of the assets of the company (to keep the

[51] § 30 subpar 2 of Company Act.
[52] KISFALUDI et al p. 365
[53] Regional Court of Budapest, Fővárosi Ítélőtábla 13. Gf. 40003/2003. sz. BH 2004/372
[54] KISFALUDI et al p. 369.

money in a safe place)[55] or concluded transactions clearly behind the normal business risks (buying diamond mine concession in Africa)[56] he acted negligently and shall be liable for damages.

Although it is clear that Hungarian courts don't establish negligence for undertaking normal business risks, there are not any more elaborated tests, precisely settled guidelines or principles formulated in an abstract level for establishing negligence (fault) of directors in Hungarian court practice or legislation yet.

The Hungarian tort law is a system of reversed burden of proof. In this system, the company (plaintiff) has to prove that it suffered damage (the fact of suffering compensable harm as well as the amount of damages) and it has to prove the causal link between the suffered damage and the director's conduct. If the company fails to prove the loss it suffered the claim is to be rejected. The same goes for if the company proved the loss but failed to prove the extent of the suffered damage although it was possible to prove it. If, however, it was, by the nature of the loss, impossible to prove the extent of the compensable damage, the court may award – as lump sum compensation – general damages.

In this system, unlawfulness is presumed. As a general principle, the conduct resulting in damages to others is unlawful and from this follows that causing harm is always unlawful. If the director can prove that in that certain case causing harm was rendered lawful by the law, he shall not be liable.[57] The system of Hungarian tort law and the general clause of basic norm of liability imply that causing harm shall always be deemed as unlawful except it was explicitly otherwise provided by the law. Thus, the director (defendant) has to prove that he caused the damage lawfully (that is, there is a norm permitting him to cause harm to the victim under the relevant circumstances) in order to exempt himself from liability.

Fault (negligence) is presumed as well: the director is liable unless he proved that he acted as it was under the given circumstances generally expected and according to the priority of the company's interests. That is, if the company proved that it suffered damage and this was the result of the director's conduct, the defendant director shall be liable except he proves that he acted according to the generally expected standard of conduct (or if he proves that causing harm in the given situation was lawful). From the system of reversed burden of proof of Hungarian tort law follows that damage and causal link between the conduct of the director is to be proven by the company. Lawfulness of the damaging behaviour or absence of negligence (fault) is to be proven by the director in order to get relieved of liability if damage and causal link was proven by the company.

The specific regulation provided in the New Civil Code for getting relief of liability for breach of contract establishes a stricter regime, as far as the basis of liability is concerned, and introduces a limitation of liability to foreseeable losses. It is impossible to assess the consequences of this change in the regulation concerning the liability of directors. The foreseeability limit presumably will not help for directors in order to get relieved of liability as the risks involved in this position were to be held as foreseeable as they accepted it. In the regime of the New Civil Code, they can be exonerated from liability by proving that the breach of contract (incompliance with required duty of care and loyalty) was caused by circumstances:

[55] KISFALUDI et al p. 370
[56] Regional Court of Szeged, Szegedi Ítélőtábla Pf. I. 20 079/2003. BDT2004. 959.
[57] EÖRSI Gyula, A polgári jogi kártérítési felelősség kézikönyve (1966) 221. The defences are such as the consent of the aggrieved person, the necessity, the authorized exercise of rights etc.

- That fall beyond their control,
- Was unforeseeable, and
- It could not be expected that they avoid these circumstances, or prevent the loss.[58]

4.2 Exemptions and limitations

There are no specific exemptions or limitations (or caps) except that in a single-member company directors may be instructed in a written form by the shareholder and if the director acted according to such instructions, he is not covered by the rules concerning directors' duties and liabilities. Directors cannot mitigate their liability without the consent of the company. If the company agrees with mitigating the liability of the directors, they can do it two ways. Either they conclude an agreement with the director on excluding or limiting the liability of the director (see below) or the general meeting of the company decides for giving discharge to the director. The memorandum of association may contain provisions for the company's supreme body to evaluate on an annual basis the work of the executive officers in the previous financial year, and to decide concerning the granting of any discharge of liability to certain executive officers. Granting a discharge of liability constitutes the supreme body's verification that the executive officers in question have performed their work during the period under review by giving priority to the interests of the company. The discharge of liability shall be abolished in the event of a subsequent court ruling declaring the information based on which the discharge of liability was granted false or insufficient.[59]

Liability of directors is covered by the general rules of liability provided in the Hungarian Civil Code. The provisions of the Civil Code allow excluding or limiting the liability for damages either in contractual or non-contractual legal relationships. If the director of the company is in a contractual relationship with the company under an agency contract (concluded explicitly or imposed by law), the liability of the director vis-á-vis the company is a liability for breach of contract and the parties can limit or exclude the liability of directors within the limits and preconditions of excluding or limiting the liability for breach of contract. According to the provisions of § 314 of the Civil Code, the liability for breach of contract caused deliberately, by gross negligence, by crime, or causing damage in life, health or physical integrity cannot be validly excluded. Liability for breach of contract – if it is not otherwise prescribed – cannot be excluded or limited unless the disadvantage derived from the exemption clause is compensated by the adequate reducing of the counter-value or by another benefit.[60] Exclusion clauses, which infringe these provisions, are regarded (as illegal ones) null and void. Thus, under agency relationship the liability for damages in case the company suffered a loss in its patrimony as a result of the director's negligent behaviour may be excluded or limited if negligence was not a gross one and if the salary of the director was reduced proportionally.

If the director was in a labour law (employment) relationship with the company, this means that there is not a private law contractual relationship between the company and the director. Although for such cases also the private law liability in torts is to be applied, this can only be a non-contractual relationship covered by the provisions of liability in tort.[61] In such a case liability for damages can be excluded or limited even in absence of adequate compensation but any contractual clause shall be

[58] § 3:21 of New Civil Code
[59] § 50 subpar 5 of Company Act.
[60] Such compensation will not be required by the New Civil Code as a prererquisite of exclusion or limitation of liability for breach of contract. § 6:152 of New Civil Code
[61] WELLMANN György, A vezető tisztségviselők polgári jogi felelőssége. Gazdaság és Jog 12/1996. pp 8-12.

null and void if it beforehand limits or excludes liability for damage proceeding from wilful or gross negligence; injury to life, physical well-being, or health; or the consequences of a crime.

Such agreements may be incorporated in the memorandum of association as well, although I have not yet any information whether companies apply such limitation or exclusion clauses or not.

4.3 Insurance against liability

Directors may be insured against the risk of being held liable with a third party insurance. Such insurance policies may be bought either by directors themselves or by the companies and there are more insurance companies offering such products.[62]

Although insurance coverage is available in Hungary for liability of directors, buying such insurance does not seem to be a widely used practice. The basic ground for that can be that insurance companies does not provide unlimited insurance but limit their obligations with fixing the highest sum of compensation they pay. For smaller companies even such limited insurance coverage may be too expensive, for larger companies the limited coverage does not provide a security they are willing to pay for.

[62] KISFALUDI et al 389.

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 The meaning of 'vicinity of insolvency'

Hungarian company law applies the concept of a situation "threatening insolvency" without providing further guidelines what exactly is to be understood under this and how the occurrence of such a situation is to be established. The Bankruptcy – establishing the liability of the (shadow) directors – provides for that a situation is considered to carry vicinity of insolvency as of the day when the directors of the company were or should have been able to foresee that the company will not be able to satisfy its liabilities when due.[63] Even if the legislator tried to avoid the uncertainties with this concept, there still remained unclear points in how vicinity of insolvency is to be assessed.

According to the prevailing view,[64] a threatening insolvency is understood to exist once the director(s) knew or should have "reasonably" foreseen that the company would not be able to pay its debts on their due dates, i.e. that the company would become insolvent. As a consequence, a threatening insolvency is determined on the basis of a liquidity forecast rather than a balance sheet test. This means with respect to a threatening insolvency that such situation occurs in the case of the company's foreseeable and expected illiquidity and irrespective of the potential positive balance of the company's assets. Other than the aforementioned liquidity forecast test there is no specific rule or procedure to establish a threatening insolvency. In addition, there is no court practice in respect of the interpretation of the term "reasonably" as this rule is a recent novelty in Hungarian law. One shall assume that the term should be interpreted as the due care and diligence of the directors which could be expected from persons holding such a position.[65]

The directors of a company may, in my view, determine a threatening insolvency on the basis of the available financial data, analyses, forecasts and plans. If such information and documents cause the directors to conclude that the company will not be able to settle its debts on time, the critical turning point has been reached and creditors' interests should be prioritized. In case of a potential threatening insolvency it is advisable that the directors proceed with due care in complying with the requirements as expected from persons holding such positions, e.g. meaning that the company's status should be monitored more frequently.

In light of the uncertainties with regard to the determination of the exact time on which a threatening insolvency situation occurs and in light of the obligation of the directors to no longer perform their duties in the interest of the company from such time onwards, but to prioritise the interests of the creditors, it is clear that directors could potentially run the risk of incurring liability in case their judgement of the situation is incorrect. Prioritising the interest of creditors in a situation which does not qualify as a threatening insolvency is clearly not in line with the interest of the company. On the other hand, waiting too long may cause liability towards the creditors. In addition even if the directors

[63] § 33/A subpar 1 of Bankruptcy Act 1991
[64] KISFALUDI et al p. 379.
[65] § 4 subpar 4 of Civil Code

correctly decide to put the creditors' interest first in a situation of threatening insolvency, the individual creditors' interests may not necessarily coincide and therefore directors may have difficulties to define "creditors' interests". However, in my view directors who are able to prove that they have take appropriate steps and measures to determine whether the company is in a threatening insolvency situation, will not be liable, even if it turns out that there decision or judgement was incorrect.

In order to avoid potential liabilities, according to my view directors shall review the economic, financial and legal situation of the company carefully, as well as future trends in this regard, and must regularly evaluate the risk of insolvency. Also, such evaluation could become necessary if any extraordinary event would occur on the company's markets or in the company's operation. Directors may consider retaining outside experts to advise the company or themselves in connection with such evaluation.

When directors evaluate whether it is reasonable or not to foresee that the company would not be able to meet outstanding claims by their due dates, i.e. whether there is a threat of insolvency, directors shall take into consideration, among others, the followings:

- The status of the company's markets, the business trends affecting the company and the economic situation of the company, as well as potential changes thereto and how the various economic problems can be handled by the directors, if at all, and in what timeframe, etc.,

- The possibility of the breach of the credit agreements of the company, particularly the violation of the financial covenants or the possibility of the violation of any agreement with any other creditors/contracting parties of the company, and the consequences of a breach (including whether the breach has a technical nature or it will be a material breach, the possibility of obtaining a waiver regarding the breach, including the analyses of the flexibility/attitude of such creditors in the past in connections with waivers, whether there were any indication by the creditors of their willingness to provide waiver to the company, general trends in financial markets for financial institutions to be flexible/provide waivers in this difficult crisis time etc.),

- The possibility of the financial support of the equity sponsor in the form of a capital increase or by other means, and

- Whether there are any other alternative financial resources available for the Company or not.

Neither the legislation nor the court practice gives rules or principles for how termination of the situation threatening insolvency is to be established. On the basis of the analysis provided above one has to conclude that threatening insolvency is terminated once the director(s) knew or could "reasonably" foresee that the company would be able to pay its debts on their due dates, i.e. that the company would not become insolvent.

5.2 Consequences

5.2.1 Liability

One of the main concepts of Hungarian insolvency law is that the general obligation of (shadow) directors to focus on the interests of the company shifts to an obligation to prioritise interests of creditors (so-called wrongful trading) in the case of a threatening insolvency. Non compliance with wrongful trading provisions may result in personal liability of the (shadow) directors. It should be noted, however, that directors will only incur liability if the company is indeed declared insolvent by court and the wrongful trading resulted in a loss of the creditors (i.e. decrease of the company's assets available for distribution to the creditors in a liquidation procedure). Directors may exonerate themselves by proving that they acted in line with the due care and diligence that was to be expected of a person in their position. This applies both to the diligence required in connection with the determination of a threatening insolvency situation and to the diligence required in connection with the measures to be taken to mitigate losses of the creditors in a threatening insolvency situation.

The obligation to act in the best interest of the creditors of the company in a threatening insolvency situation applies to all individuals who served as directors or acted as *de facto* directors (shadow directors) in the 3 years prior to the commencement of a liquidation procedure (i.e. the date of publication of the final and binding court order on the commencement of the liquidation procedure in the official gazette). Claims against directors and/or shadow directors based on wrongful trading may be enforced in a two-stage procedure. During liquidation proceedings, the creditors or the liquidator may apply to court for a declaratory judgement establishing that in a situation of threatening insolvency the directors breached their obligation to manage the company in line with the concept of giving priority to the creditors' interests, and as a result the company's assets decreased to a certain extent for which the director is liable. After the conclusion of liquidation proceedings, creditors with unsatisfied claims have 90 days to apply to court for an order requiring the directors to satisfy these claims, which could have been satisfied had the company's assets not decreased as a result of the wrongful trading of the directors.

The obligation of directors to focus on the primary interests of the company's creditors in case of a threat of insolvency does not mean an objective liability of directors (i.e. insolvency and liquidation proceedings do not automatically trigger the above referred liability directors). If directors carried out their tasks in accordance with the diligence that could generally be expected of a person in such position when they evaluate whether the company is in a situation of threatened insolvency or not, and they conclude that the company is not threatened by insolvency, but later the company would become insolvent, this does not mean that they are liable for such conclusion. Also, if directors believe, on the basis of reasonable and justifiable grounds, that the company is threatened by insolvency and it is reasonable to believe in the given circumstances that taking certain specific measures would serve the interests of the creditors of the company, but it later becomes apparent that taking such measures was detrimental to the interests of the creditors in the prevailing circumstances, directors cannot be held liable for their decision.

Directors will not be held liable for losses of creditors, if they are able to prove that they have taken all measures as could be expected in the respective situation in order to mitigate losses of the creditors. There is no clear statutory guidance for directors as to what is expected of them and what measures should be avoided. The only case where non-compliance with directors duties is presumed by law is if the director has not complied with his obligations to submit and publish the financial statements of the company.

According to the ministerial comments to the Bankruptcy Act the measures expected to be taken or not to be taken by management in the interest of the creditors in a threatening insolvency situation are to be established by court practice. The conducts establishing liability under this regime may be manifold. E.g. if the director was simply passive and abstained from acting, this may itself establish liability.[66] Loss in the company's assets due to the acts of directors,[67] or decision providing loan to another company and reducing the assets under the capital[68] may also establish this liability. The (shadow) directors are, however, not to be held liable for all of the debts of the company. Their liability covers only debts that remained uncovered in the company's assets due to (in causal link with) their conduct that was incompliance with the duty of loyalty to creditors.[69]

According to my view that in the event of a threatening insolvency the convention of the shareholders' meeting of the company and due information of the shareholders, are measures which are likely to be expected from directors. Otherwise, I think that measures to be taken in the interests of the creditors should be determined on a case by case basis, based on common business sense and the actual circumstances of the company. It should be noted that directors may be required to consider that certain measures may be more beneficial to the financial status of the company if taken in a good time, i.e. before illiquidity and/or insolvency has been declared. For example, certain of the company's business units or assets may be sold at a higher price as a whole and while the business is still on-going and contracts are existing, than later when contracts may have been terminated due to insolvency or non-payment and/or where employees have been dismissed. These factors may cause a down turn in the business. In addition, selling the business on time may save significant costs, which otherwise would have to be borne by the company and which may have priority over general creditors' claims.

In respect of measures which should not be taken, legal literature mentions that critical actions such as entering into very risky transactions with a view to achieve extremely high proceeds may fall in the scope of non-preferred measures as they may likely deteriorate the position of the creditors. When entering into contracts and/or transactions directors should ask themselves whether in the specific situation such actions are to be considered diligent or not.

Duty of reporting to the shareholders: under the Companies Act, directors shall, with simultaneous notice to the supervisory board, call a general meeting within a period of eight days in order to provide for the necessary measures if (i) the Company's equity has dropped to two-thirds of the registered capital due to losses; or (ii) the equity of the Company has dropped below the minimum amount applicable for companies limited by shares; or (iii) the Company is on the verge of insolvency or has stopped making payments and its assets do not cover its debts. Once directors reported the loss to the shareholders and called the general meeting, did comply with this duty. If the general meeting decides for consolidating the financial situation of the company and if yes, how, is not covered by duties of the director.

[66] Supreme Court, Legf. Bír. Gfv. IX. 30.249/2010., EBH2011. 2326
[67] Supreme Court, *Legf. Bír. Gfv. X. 30.361/2010.,* BH2012. 101
[68] Regional Court of Pécs, Pécsi Ítélőtábla Gf. II. 30 266/2009/7. BDT2010. 228
[69] Regional Court of Szeged, Szegedi Ítélőtábla Pf. I. 20 498/2010., BDT2012. 2619

5.2.2 Other sanctions

Company law and bankruptcy (insolvency) law regulation cover this issue in Hungarian law. Directors may incur criminal liability as a result of non-compliance with their managerial obligations in the specific cases as set forth in Act No. IV of 1978 of the Hungarian Criminal Code. Such cases may include the (i) violation of accounting regulations, (ii) criminal bankruptcy, (iii) illegal conduct by executive persons of economic entities, (iv) actions which cause the equity capital to be used up against capital maintenance rules, and (v) failure to comply with general financial reporting obligations. The consequences of criminal liability may include imprisonment, community service work, a fine and/or restraint from profession (as an ancillary punishment).

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue?

6.1.1 The company as plaintiff

Consequences of breach of fiduciary duties are liability for damages or – in case of incompliance with the anti-competitive requirements – restoration of unjust enrichment. As consequences of breach of duty remain in the frame of private law, claims may be enforced in a civil procedure, either in a litigation at an ordinary court or in arbitration. Plaintiffs can be the stakeholders to whom the directors owed the fiduciary duty that had been violated: the company or the creditors.

If fiduciary duties owed to the company had been violated, the company may launch the procedure with submitting in the claim only if the general meeting of the company decided for that. If the general meeting did not decide for that, minority shareholders having at least five percent of votes may initiate such procedure by submitting in the claim in the name of the company.

6.1.2 The shareholders as plaintiffs

6.1.1.1 In their own name

Shareholders cannot enforce a claim in their own name neither public bodies have the authority to initiate such a procedure. After termination of the company without succession, claims for damages may be brought against the directors by the shareholders who were members at the time of the cancellation of the company by the court of registry, within a period of one year following such cancellation by a final ruling.[70]

6.1.1.2 In the name of the company (derivative action)

The persons to whom the directors owed the fiduciary duty that had been violated can sue the director. If the fiduciary duty owed to the company was violated, only the company can sue the director with claiming damages. Shareholders are not entitled to claim damages for themselves. With exercising the rights provided to minority shareholders, shareholders having at least five percent of the votes may claim damages but only if the general meeting did not decide to enforce the claim of the company and they can sue only in the name of the company. Thus, if on the basis of a claim submitted under minority protection rules the court award damages, damages are to be paid to the company.

In context of the derivative claims brought to the court under the minority protection regime, the company is always formally party to the proceedings, and not the minority shareholders who use the derivative action. The plaintiff is always the company, the minority acts on behalf of the company as

[70] § 30 subpar 6 of Company Act 2006 and § 3:102 subpar 3 of New Civil Code

an agent or legal representative. Regulation gives the right to minority to submit the claim in the name of the company (representing it) but not in their own name. The reason of this is that the prevailing view holds it as incompatible with the structure of civil procedure that it is not the obligee, who acts as plaintiff (someone is claimant but another person is entitled to collect the money if awarded).

As far as bearing the costs is concerned, for this derivative action there is no specific rule in the Hungarian company law legislation. The claimant is the company and the claimant (the company) has to pay the costs in advance; the minority, however, gets the right to represent the company in the civil procedure but does not get the right to dispose over the financial assets of the company. If directors decide not to let to pay the costs of the procedure, the minority has to do that in order to avoid dismissing the claim already at the outset. The minority, however, may have a claim against the company on the basis of restitution of unjust enrichment on the ground that they paid - instead of the company - the costs which was a debt of the company at the civil procedure. So, in the end of the day, it may be true, that the minority shareholders who instigate the derivative action do not face any costs.

6.1.3 Action brought by third parties

If the fiduciary duty owed to creditors had been violated (i.e. in the vicinity of insolvency the director failed to act according to the priority of creditors' interest).

6.2 Administrative and criminal sanctions

The consequences of breach may be private law consequences: damages or restoration of unjust enrichment. Breach of statutory duties does not result in administrative or criminal consequences. If the conduct of director that falls into the scope of this report, at the same time falls into a specified crime as well (fraud, insider trading, bankruptcy crime, abuse of position, e.g. by disclosing or broadcasting false information concerning the financial position of an economic operator or the executive officer of such economic operator in connection with his office, or concerning financial instruments in relation to the economic operator, or by concealing information or by concluding any fictitious transaction relating to financial instruments) a specific sanction of restraint of profession may be imposed on him.

Restraint of profession may be imposed upon a person who has engaged in a crime through the violation of the rules of his/her profession requiring special qualification; or knowingly, by using his profession. Restraint of profession shall be imposed upon a person who has committed the crime against the integrity of public life knowingly, by using his profession. With respect to applying restraint of profession, the concept of profession shall also cover if the offender is a member or director of a body exercising general control of an economic operator, a member of the board of directors or supervisory board of a cooperative, or the executive officer of a company or a member of its supervisory board, or a private entrepreneur. A restraint of profession may be perpetual or for a specific period of time. A person who is unsuitable or unworthy for the profession in question may have the privilege restrained permanently. The specific term of restraint shall be one year minimum and ten years maximum.[71]

[71] § 56 and 57 of the Act no. IV of 1978 on the Criminal Code

DIRECTORS' DUTIES AND LIABILITY IN IRELAND

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CONTENTS

1 INTRODUCTION

This country report on directors' duties and liabilities in Ireland outlines the law in this jurisdiction as a common law jurisdiction which shares many common principles with those applicable to directors in the United Kingdom given their shared legal heritage.

1.1 Corporate law and directors' duties in Ireland

Registered companies in Ireland are creatures of statute law, but the statutes are by no means a complete code of company law. A considerable body of law produced by judicial decision must also be allowed for. The principal Act is the Companies Act 1963, modelled closely on the UK Companies Act 1948. The Companies Acts 1963-2012 apply.

Directors' duties are currently in the form of judge-made law, which have some statutory supplementation to bolster the rules on conflicts of interest. Initially these rules developed in the English courts based on an analogy between the fiduciary role of the trustee and the fiduciary role of the director. The modern policy justifications for these rules rest on agency theory and the well-known concept of transaction cost savings propounded by law and economics theorists. Following the work of the Company Law Review Group, it is planned to introduce a single consolidating Companies Act along the lines of the UK's Companies Act 2006 which will involve codifying the equitable and common law duties of directors.

Decisions of the English courts have persuasive force where no pronouncement has been made on the relevant issue by the Irish courts. This is important as there is little indigenous case law on directors' duties. Academic writings on company law and directors' duties in Ireland include textbooks and practitioner texts and journal articles.[1] These would be cited as authority in the courts and are from time to time referred to in judicial decisions.

[1] The leading text on company law is TB Courtney, *The Law of Private Companies* Butterworths, 2nd ed, 2002. The leading text on Directors' Duties is D Ahern, *Directors' Duties: Law and Practice* Round Hall, 2009.

1.2 Corporate Landscape in Ireland

The following types of company operate in Ireland:

Type of company	Regulatory framework	Nature of ownership	Board structure
Private Limited Company	Companies Act 1963, s.207(1)(d)	Private ownership	One tier
Private Unlimited Company	Companies Act 1963, s.5(2)(a)	Private ownership	One tier
Public Limited Company (plc)	Companies Act 1983, ss.5(2), 19(1) and 17(1)	Private ownership	One tier
Guarantee Company	Companies Act 1963, s.5(2)(b)	Private ownership	One tier
Statutory Corporations	Specific legislation such as the Electricity Supply Act, 1927	Mostly state-owned public corporations	One tier
State Companies	Companies Act, 1963, s.207(1)(d)	State-owned, but subject to the Companies Acts 1963-2009	One tier

In Ireland, over ninety per cent of companies are private limited companies with the majority of these being small ventures where there is an overlap between shareholders and directors.[2] The unlimited company model is therefore employed in cases where more than twenty persons or more than ten in the case of bankers wish to engage in business in common, but for one or other reasons – such as tax avoidance - opt for unlimited liability. Guarantee companies are companies with members but not shareholders. Their members undertake or guarantee to be responsible for all unpaid debts in any given instance up to a prescribed amount. The extent of their liability to the company is defined by the terms of their guarantee. Most statutory corporations that engage in commercial or industrial activity – such as the Radio Telefís Éireann (the national broadcaster),[3] the Electricity Supply Board[4] and the Voluntary Health Insurance Board[5] - are state-owned or public corporations. State companies are companies registered under the Companies Acts, but whose internal regulations contain various provisions specified in the legislation which authorised registration of the company in question. Such companies as Coillte (the Irish Forestry Board Ltd) and Aer Lingus were originally established in this manner. Ireland has a long history of semi-state companies. However, this company type is now of relatively minor importance - over ninety per cent of companies are private limited companies.

There are less than 30 companies listed on the Main Securities Market of the Irish Stock Exchange. Market capitalisation of companies included in the ISEQ indices was €86.9bn at end of December

[2] Statistics on the patterns of share ownership in Ireland are not available.

[3] Broadcasting Authority Act 1960.
[4] Electricity (Supply) Act 1927.
[5] Voluntary Health Insurance Act 1957.

2011.[6] Under the Listing Rules of the Irish Stock Exchange, these companies follow the *UK Corporate Governance Code* and an *Irish Corporate Governance Annex* on a 'comply or explain' basis.

The *Companies Acts 1963-2012* apply to all types of companies unless specifically excluded.

1.3 The Board of an Irish Company

Boards of Irish companies are unitary in structure. Dual board structure is not provided for.

Employee participation is not provided for in relation to domestic forms of company. Worker directors are elected to office in semi-state companies in Ireland.[7] Management in the private sector are obliged to consult with employees on a range of matters. For instance, when a company is likely to face insolvency and also in matters of health and safety.[8]

Shareholders are regarded as having delegated day-to-day management to the board of directors pursuant to Model Regulation 80 and therefore cannot give directions to the board other than by altering the company's memorandum and articles of association.[9]

[6] *ISE Quarterly Statistical Report for Q4 2011* (February 2012).
[7] Worker Participation (State Enterprises) Acts 1977 to 1993.
[8] Transnational Information and Consultation of Employees Act 1996, Worker Participation Acts 1977/88 and the Safety, Health & Welfare Act, 1989, Protection of Employment Act, 1977.
[9] See D Ahern, *Directors' Duties: Law and Practice* Round Hall, 2009 at paras 2-104 to 2-117.

2 THE CONCEPT OF 'COMPANY DIRECTOR' IN IRELAND

2.1 De iure directors

2.1.1 Requirements to become a de iure director

Companies in Ireland, including single member companies, are required to have a minimum of two directors.[10] There is a general requirement that companies registered in Ireland have at least one Irish resident director.[11]

Company law in Ireland is in many respects very similar to that of the company law of England and Wales. For instance, the definition of director found in the UK Companies Act 1908 and subsequent legislation – that is: ''any person occupying the position of director by whatever name called'' - applies in the Irish context.[12]

The term executive director is generally understood to refer to a director who is involved on a full-time basis in the management of the company's affairs. They are often full-time employees of the company and are remunerated in accordance with the professional commitment involved. Although well understood in business life in Ireland, the concept of an executive director has not been given a distinct legal shape in Irish company law. In practice, there is an implicit assumption that all directors are executive directors. Nevertheless, the Irish courts have increasingly had regard to the differing responsibilities of executive directors in comparison with their non-executive colleagues.

Irish courts very clearly regard executive directors as being the chief officers of the company and impose both statutory and non-statutory duties upon them. While all directors are regarded as having duties with which they must comply, executive directors are regarded as having the primary duty in compliance matters. This has been emphasised in restriction and disqualification cases. Such cases have highlighted the role of executive directors. In *Re Tralee Beef and Lamb Ltd (In Liquidation); Kavanagh v Delaney*[13] Finlay Geoghegan J indicated very clearly the responsibility of executive directors to bring relevant matters to the attention of non-executive directors. The non-executive directors' duties were taken to be more limited in nature.

Non-executive directors do not give themselves full-time to the management of the company. Their primary role is to participate in major policy decisions. What such directors bring to the company are their experience and skill set: they are considered as enablers of better decision- making at board level. In this regard, the UK Corporate Governance Code has had an impact on thinking about the role

[10] Companies Act 1963, s.174.
[11] Companies (Amendment) (No2) Act 1999, s43.
[12] Companies Act 1963, s.2(1).
[13] [2004] IEHC 139, [2005]1 ILRM 34.

of non-executive directors in Ireland[14]as have the earlier Hampel[15] and Higgs[16] corporate governance reviews.

Non-executive directors are recognised by the market as a distinct category of directors with differing responsibilities to those of hands-on executive directors. The law has not been as quick, however, to take full account of the non-executive director's status. As noted above, the policy of the Irish legislature has been to define ''director'' in broad terms with no specific recognition of sub-categories of director. Consequently, the law has sought to impose standards on directors irrespective of whether they are executive or non-executive. Although the Companies Acts 1963 to 2012 do not allow for any distinction between executive and non-executive directors, in practice the distinction is a critical one.

A key aspect of the non-executive director's role is that of oversight. In restriction and disqualification cases, the courts will focus on the oversight role of non-executive directors. It is sometimes contended that non-executive directors can only be expected to perform an oversight role in relation to information given to them or which they ought to have requested. It is in this context that the duty of care, skill and diligence will be applied.[17] This perspective is evident in *Re Doherty Advertising Ltd (In Official Liquidation); Stafford v Beggs*[18] where O'Leary J stated that there was a long-standing lack of reliable accounting and other information prior to the company's demise. He expressed the view that the non-executive directors should have insisted on receiving cash flow projections. He did not, however, regard non-executive directors as being obliged to take the responsibility for the improper operation of a bank account or defective invoicing procedures. Declarations of restriction were not made.

While the concept and function of a managing director or chief executive officer is well recognised in business life, the Companies Acts 1963 to 2012 do not give specific recognition to the existence of the managing directors as a separate category of director. There is, however, an exception to this in Regulation 110 of the Table A model articles in the Companies Act 1963.

There are no prior qualifications for appointment to the office of director. This stands very much in contrast to the demanding duties which the law imposes post-appointment. For instance, the Irish High Court has indicated that ''every director must be deemed to know and appreciate the distinction between the Company and themselves as individuals.''[19]

The Companies Acts 1963 to 2012 do not state which organ of the company has the task of appointing directors. Consequently companies are free to determine the arrangements, be they by means of the general meeting or the board of directors or both. The appointment of the directors is, however, a standard function of the shareholders in general meeting and the courts have regarded the shareholders as having such power.[20]

Generally, the initial composition of the board of directors of a company will be determined by the subscribers to the memorandum. If Regulation 75 of the model articles in the Companies Act 1963 is

[14] Financial Reporting Council (UK), Combined Code on Corporate Governance (2008), Principle A1.
[15] *Final Report of the Committee on Corporate Governance* (The Hempel Report) (London, 1998).
[16] *Review of the Role and Effectiveness of Non-Executive Directors* (The Higgs Review) (London, 2003).
[17] R.Reid, "Company Directors- Collective or Functional Responsibility'' (2006) 27 Co. Law.170 at 176.
[18] [2006] IEHC 88; unreported, High Court, O'Leary J., March 13, 2006.
[19] *Re XNet Information Systems Ltd(In Voluntary Liquidation); Stafford v Higgins,* High Court, unreported, Finlay Geoghegan J.',May 6, 2004 at 10.
[20] *Worcester Corsetry Ltd v Witting* [1936] Ch440.

adopted, it gives the subscribers to the company memorandum or a majority of them the right to choose the first directors.[21]

As well as a statutory written consent to act, there is also a common law requirement of informed consent.[22]

2.1.2 Who can be a de iure director

The Companies Acts 1963 to 2012 do not provide for a minimum age for appointment as a director although it is planned to introduce a minimum age of 18. A body corporate cannot be appointed as a director.[23]

There is a prohibition on the appointment of a person who is an undischarged bankrupt.[24] There is also a prohibition on a director acting as a company auditor.[25] In cases where a person is subject to a restriction order imposed following the insolvent liquidation of a company (the order is effective for a five year period), he or she can only act as a director where the company meets minimum capital requirements under the Companies Act, 1990.[26] A person who is the subject of a disqualification order or a deemed disqualification under section 160 of the Companies Act 1990 cannot act as a director for the period of disqualification.

2.2 De facto and shadow directors

Despite the overarching quality of the definition of director chosen by the Irish Parliament (the Oireachtas),[27] in the business world formally appointed directors break down into two main categories, executive directors and non-executive directors. Although well established as a feature of the business world, the division of the board of directors into executive and non-executive directors is not, however, recognised in the Companies Acts 1963 to 2012. In addition to the formally appointed *de iure* directors, other persons may be classified within the category of director. Following trends in the UK, the Irish courts and the Irish Parliament have allowed for these others: this reflects the common understanding that conduct in specific contexts is indicative of directorial duties and should be viewed by the courts as such. This has brought about the recognition of shadow directors and *de facto* directors.

The concept of a *de facto* director is not given recognition in the Companies Acts 1963 to 2012 but has been recognised by the Irish courts. In *Re Lynrowan Enterprises Ltd*[28] O'Neill J. took the view that the public protection objective of the restriction regime under s.150 of the Companies Act 1990 allowed for the inclusion of *de facto* directors within the definition of a director provided in s.2(1) of the Companies Act 1963.

[21] Companies Act 1963, First Schedule, Table A, Part 1.
[22] *Re Kelly Technical Services (Ireland) Ltd (in Vol. Liq.); Kavanagh v Kelly* [2005] IEHC 421.
[23] Companies Act 1963, s.176.
[24] Companies Act 1990. s.169.
[25] Companies Act 1990, s.187(2)(a).
[26] Companies Act 1990, s.150.
[27] Companies Act 1963, s.2(1).
[28] Unreported, High Court, O'Neill J., July 31, 2002.

As the *de facto* director designation has important consequences for the individual, the Irish courts have sought to clarify when it is reasonable to classify someone as a de facto director. In *Re First Class Toy Traders Ltd; Grey v McLoughlin*[29] Finlay Geoghegan J. stated that ''essentially a de facto director is a person who assumes to occupy the position of a director or assumes to act as a director of a company.''[30]

In an Irish context, a *de facto* directorship will most frequently come into being because of inadvertence on the company secretary's part. The relevant provisions of the memorandum and the articles of association are likely to have been overlooked. A person may be a *de facto* director in such cases as the following: he or she may have taken on the role of decision- maker. Moreover, this decision-making may be of such a nature as to be characteristic of the function of the board, rather than purely advisory or managerial in nature.

Under the terms of the Companies Act 1963-2012 someone who has not been formally appointed to the position of director may nevertheless be regarded in law as a shadow director. This may be on view quite clearly: the legally appointed directors may simply comply with their directions or instructions. The inclusion of the concept of a shadow director in section 27 of the Companies Act 1990 was inspired by the introduction of the concept in s.741 of the UK's Companies Act 1985. The reason for s.741 was to bring these persons who very much determined proceedings at board level within the sphere of duties and obligations of directors.

Section 27 of the Companies Act 1990 defines a shadow director as someone who, while not formally appointed as a director, is deemed to be such because he or she is a person ''in accordance with whose directions or instructions the directors of a company are accustomed to act.'' The exception allowed for is where the person is offering professional advice.[31] The law recognises that shadow directors have no legal power to be regarded as representatives of the company; this is not, however, regarded as an impediment to the imposition of duties on them given their considerable role within the company.[32]

As in the English courts, the case law in Ireland on shadow directors focuses on whether the person is giving instructions of directions of a sufficiently imperative nature in order to be classed as a shadow director.

The matter of the controlling influence in the boardroom is the main consideration.. In *Re Vehicle Imports Ltd (In Liquidation)*[33], Murphy J found that the company's accountant who had responsibility for maintaining and auditing the company was a shadow director. In that instance, evidence was provided by a *de iure* director to that effect and the evidence was not challenged. Murphy J. stressed, however, that the mere fact of acting as an accountant providing services to a company would not prove in any way that the accountant was a party under whose directions or instructions the directors of the company were habitually obliged to comply.

[29] Unreported, High Court, Finlay Geoghegan J., July 9, 2004.
[30] Unreported, Hhhigh Court, Finlay Geoghegan J., July 9, 2004 at 3.
[31] This definition was based on s742(2) of the Companies Act 1985 (UK).
[32] Section 27 of the Companies Act 1990 indicates that a shadow director is to be treated as a director of the company for the purposes of Part3 of the Act which is headed ''Transactions involving Directors.''
[33] Unreported, High Court, Murphy J., November 23, 2000.

The case law on shadow directors indicates that, to come within the definition in s.27 of the Companies Act 1990, the person must be giving directions or instructions which are effectively a diktat. Whether the words or conduct of a person are to be judged as a direction or instruction is to be determined in the light of all the evidence. What is required is this: the board can be seen as being ''accustomed to act'' in cases where there is a positive response on their part to the receipt of instructions or directions, but the giving of instructions as such is not itself sufficient unless there is a positive response on the part of the board.[34] The shadow director activity is effective from when the directors become accustomed to act in accordance with his instructions or directions, but has no retrospective application.[35]

The question of whether a corporate body could be afforded shadow director status has been controversial given that corporate *de iure* directors are not permitted. In *Re Worldport (Ireland) Ltd (In Liquidation)*[36] the Supreme Court regarded the status of a shadow director as a distinct category of director and held that a body corporate could be a shadow director for the purposes of s.27 of the Companies Act 1990. However, unlike the High Court, the Supreme Court took the view that a restriction order provided for in s.150 of the Companies Act 1990 would have no meaning as regards a corporate body that could not act as a *de iure* director in accordance with the law on corporate directors as found in s.176 of the Companies Act 1963.

[34] *Ultraframe (UK) v Fielding* [2005] EWHC 1638 (Ch) , para 1278, per Lewison J..
[35] *Ultraframe (UK) v Fielding* [2005] EWHC 1638 (Ch) , para 1278, per Lewison J..
[36] [2005] IEHC 189; unreported , High Court, O'Leary J., February 16, 2005; [2008] IESC 68, [2012] 1 I.L.R.M.241.

3 THE SCOPE OF DIRECTORS' DUTIES UNDER IRISH LAW

3.1 Types of directors' duties

The duties imposed on directors under Irish law are common law and equitable duties which mirror those imposed under English law prior to their codification in Part 10 of the Companies Act 2006. There is a duty to exercise care, skill and diligence which can be recognised as being both common law and equitable in scope and as non-fiduciary in nature.[37] There is an equitable duty to act in the best interests of the company[38] and recognition of the separate standing of the duty to act for proper purposes.[39] Finally, there is a dual-pronged equitable duty to avoid conflicts of interests and secret profits.[40] It is proposed that these duties will be placed in statute as part of a drive to produce a single consolidating and reforming Companies Act, based on the work of the Company Law Review Group.[41]

The Companies Act 1990 also supplemented the no conflict rules by providing additional rules in relation to loans to directors and connected persons and substantial property transactions involving directors and connected persons.

Additional statutory rules also relate to reckless trading[42] and fraudulent trading.[43]

In Ireland, the corporate law system has its inspiration in freedom of contract principles. A director's relationship with his or her company is thus a contractual one based on the memorandum and articles of association and other relevant contractual agreements, such as service contracts and shareholders' agreements. The following is also applicable: directors' powers are regulated by the Companies Acts 1963 to 2012 and the non-statutory duties which have been evolved by the courts.

While it possible to build in contractual protections in respect of the conduct of directors, it is generally not possible to diminish the equitable and common law duties of directors which have evolved since their origins in the nineteenth century. In this context, this is an example of agency theory whereby the law supplies duties and thereby provides transaction costs savings to parties who would otherwise have to negotiate equivalent contractual protections.

It can be said also that the market in this instance has a regulatory function. In the case of companies whose shares are publicly traded there is competition for directorial appointments and consequently

[37] This duty has its origins in *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407.
[38] *Re Smith and Fawcett Ltd* [1942] 1 All ER 542.
[39] *Banfi Ltd v Moran* [2006] IEHC 257.
[40] *Aberdeen Railway Co v Blaikie Bros* [1843-1860] All ER Rep 249; *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378.
[41] See generally, D. Ahern, "Legislating for Directors' Duty to Exercise Care, Skill and Diligence in Ireland: A Comparative Perspective" (2010) 8 *International Company and Commercial Law Review* 268; D. Ahern, "Legislating for the Duty on Directors to Avoid Conflicts of Interest and Secret Profits: The Devil in the Detail" (2011) 46 *The Irish Jurist* 82.
[42] Companies Act 1963, s.297A.
[43] Companies Act 1963, s.297 and s.297(1)(b).

the market may impose some constraint on managerial conduct. This may apply through bonuses and remuneration linked to personal performance.

In addition, the view often found among interested parties in Ireland – influenced by Anglo-American thinking - is that the most cogent rationale available to explain the imposition of directors' duties is that derived from agency theory. Agency theory permits directors to be conceived of as rational actors who may act in their own interests, where the opportunity presents itself, provided that operational external constraints on their behaviour are not high.[44] This tendency of agents to pursue their own interests at the expense of their principal is to be held in check – the theory holds- by imposing controls on the agent. An agency analysis recognises that the influence of contractual constraints may be insufficient and of relevance only in those companies where there is a separation rather than a convergence of control.[45] On the other hand, and in contrast to the North American approach, the 1990 Companies Act besides being stringent as regards director conduct and ethics (which would also be found in North America corporate legislation) is more encompassing as regards the interests to be considered by the board. Section 52(1) of that Act stipulates that directors owe a duty to ''consider the interests of the company's employees in general, as well as the interests of its members''.[46]

Where more than one director is involved in the breach of a director's duties, their liability is joint and several.[47] The concept of accessory liability does not apply to directors, only to assistance by third parties who are not directors. In cases of assistance to a director who has been the prime mover, the assistance may be of such a nature and extent as to independently incur sanction. Another issue is this: can any liability attach to directors who have failed to spot breaches of duty on their colleagues' part? It is perfectly reasonable to argue that the lax directors should be subject to liability for breach of their duty, because they have failed to exercise care, skill and diligence in the performance of their duties.[48] This point has yet to be determined by the Irish courts.

When considering which remedies to seek or award against an offending director in the Irish context, there is much to choose from. A court will be mindful of what is known as the rule against accumulation of inconsistent remedies. The purpose here is to avoid a form of double compensation. This rule was enunciated by Lord Nicholls, delivering the Privy Council's advice, in *Tang Man Sit (Personal Representatives) v Capacious Investments Ltd.*[49] Lord Nicholls emphasised that where the law provides remedies which are inconsistent with each other, they are treated in law as being alternative to one another and are not to be thought of as cumulative. The rule also has application in some circumstances where more than one cause of action is available. It was held in *Coleman Taymar Ltd v Oakes* [50] that a company was entitled to choose whether or not to claim damages or an account of profits against a director for a fiduciary breach of duty. It was not possible to claim for both, however, as both offences were in breach of statutory duties. Thus, having opted for an account of profits in respect of a breach of duty as a director, the company could not in addition claim damages for breach of contract arising out of the same actions.

In Ireland, the application of a statutory remedy such as the imposition of personal liability on a director for the company's debts on the basis of having caused the company to engage in reckless trading is without prejudice to the possible additional sanction of a restriction order under s.150 of the Companies Act 1990 or a disqualification order under s.160 of the 1990 Act.

[44] This argument is developed in D Ahern *Directors' Duties: Law and Practice* Round Hall, Dublin, 2012 , Chapter 7.
[45] F. H. Easterbrook and D.R.Fischel, *The Economic Structure of Corporate Law,* (Cambridge, Mass.: Harvard University Press, 1991) is the formative text in this regard.
[46] Companies Act 1990, s52(1).
[47] *Re Carriage Cooperative Supply Association* (1884) 27 Ch. D. 322.
[48] *The Marquis of Bute's Case(sub nom in re Cardiff Savings Bank)* [1892] 2 Ch 100.
[49] [1996] 1 All E.R. 193.
[50] [2001] 2 BCLC 749.

Model articles 83 to 87 of Table A to the Companies Act 1963 deal with avoidance and regulation of conflict of interest situations arising between the director's personal interests and those of the company for whom he is acting.

3.2 To whom are the duties owed?

The duties of directors are regarded as being owed to the company.[51] The company's interests can be viewed in a number of different ways. The interests of a company may be regarded as those of the separate legal entity of the company. However, commonly, under the concept of shareholder primacy, the interests of the company are equated with the collective interests of the shareholders. In Ireland there has yet to be a decisive move in that direction regarding the company as a constituency of stakeholder interests. However, in certain contexts the interests of third parties will be relevant.

The general proposition stemming from the recognition of the separate legal personality of companies is that where a company is part of a group of companies, the directors of each company must act in the interests of that company without regard to the interests of the wider group or another company within that group.[52] However, in *Re PMPA Garage (Longmile) Ltd*.[53] it was judicially recognised that the best interests of the company may be served by ensuring the survival of other group companies, in this case through guaranteeing their loans. In *Re PMPA* Murphy J. went so far as to regard it is a general proposition that, in discharging his or her duties to a company within a group, a director is entitled to consider the interests of the group as a whole. The subsequent Supreme Court decision in *Re Frederick Inns Ltd*[54] indicated that this approach would not be appropriate where a company's solvency was in doubt.

Although for the most part the case law supports the interests of the company being equated with the artificial legal entity that is the company, there are cases where the courts have viewed the interests of members as synonymous with those of the company.[55] In *G & S Doherty Ltd v Doherty*[56] Henchy J. stated that directors in exercising the power of allotment are obliged to exercise "… their power bona fide for the benefit of the company as a whole, that is to say, the shareholders as a whole."[57] This perspective is also seen in *Irish Press Plc v Ingersoll Irish Publications Ltd*[58] where Barron J. stated

that "…acting in the interests of the company is no more than acting in the interests of all of its shareholders."[59] The Irish courts have yet to pronounce on the issue of whether the interests of shareholders should be taken to include the interests of future shareholders. This is an interesting question since existing shareholders may be happy with short-term profit maximisation at the expense

[51] *Percival v Wright* [1902] 2 Ch 421. *Dawson International Plc v Coats Paton Plc* [1989] B.C.L.C. 233; *Crindle Investments v Wymes* [1998] 4 I.R. 567, [1998] 2 I.L.R.M. 275. The rationale for this is that, while the company is a going concern, rather than being a trustee of its own funds, a company is their beneficial owner and neither shareholders nor creditors have a proprietary interest in the company's assets: *Belmont Finance Corporation Ltd v Williams Furniture Ltd (No. 2)* [1980] 1 All E.R. 393, 405, per Buckley L.J.
[52] *Re Pollypeck International Plc (In Administration)* [1996] 2 All E.R. 433, 444, per Robert Walker J.
[53] [1992] 1 I.R. 315.
[54] [1994] 1 I.L.R.M. 387.
[55] This view of the company's interests being primarily those of the members is also supported by s.52 of the Companies Act 1990.
[56] High Court, unreported, Henchy J., June 19, 1969.
[57] *ibid.* at 22.
[58] High Court, unreported, Barron J., December 15, 1993.
[59] *ibid.* at 77.

of the future state of the company. In *Gaiman v National Association for Mental Health*[60] Megarry J. regarded the question of the best interests of the company as having to be determined on the basis of having regard to the interests of both present and future members.

The *Coleman v Myers*[61] formulation of a duty to individual shareholders based on an exceptional relationship of trust and confidence has been assimilated by the Irish Supreme Court in *Crindle Investments v Wymes*.[62] The courts have also been prepared to recognise that duties may be owed to a shareholder in an individual capacity, where what is at issue is not the collective interests of the corporate entity, but rather the interests of a shareholder *qua* individual.[63]

Although the Irish courts have not pronounced authoritatively on the question of the duties owed by nominee directors, in *Irish Press Plc v Ingersoll Irish Publications Ltd*[64] Barron J. stated:

> "There is nothing wrong with the appointing body or party having a view as to where the interests of the company lie and ensuring that its nominees follow that direction provided that in so doing they are not seeking to damage anybody else's interest in the company."[65]

There is no common law duty to consider the interests of employees.[66] Section 52 of the Companies Act 1990 requires directors to consider the interests of the company's employees as well as the interests of members. This provision was modelled on the s.309 of the UK's Companies Act 1985 and is not considered to be significant in practice given the lack of a direct enforcement mechanism.

In *Jones v Gunn*[67] McGuinness J. noted that while *Percival v Wright*[68] established that directors owed their duties to the company as a whole and not to individual shareholders, the decision did not consider the position of creditors. As a general proposition the courts have not regarded directors as owing duties to the creditor body or to individual creditors.[69] However, as discussed below, the courts have recognised a limited duty on directors to consider the interests of creditors when the interests of the creditors intrude on the company being wound up, on occasion where a company is insolvent and even where insolvency is simply looming on the horizon.[70]

3.3 The director as shareholder

While there has not been a ruling on the point, it would appear to be axiomatic that the duties only apply when a director acts *qua* director rather than *qua* shareholder.

[60] [1971] Ch. 317.
[61] [1977] 2 N.Z.L.R. 225.
[62] [1998] 4 I.R. 567, [1998] 2 I.L.R.M. 275.
[63] *Securities Trust Ltd v Associated Properties Ltd* High Court, unreported, McWilliam J., November 19, 1980.
[64] High Court, unreported, Barron J., December 15, 1993.
[65] *ibid.* at 77.
[66] *Sweeney v Duggan* [1997] 2 I.R. 531.
[67] [1997] 3 I.R. 1, [1997] 2 I.L.R.M. 245.
[68] [1902] 2 Ch. 421.
[69] *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] Ch. 258, 288, per Dillon L.J.; *Yukong Lines Ltd of Korea v Rendsburg Investments Corpn of Liberia, The Rialto (No. 2)* [1998] 4 All E.R. 82, 99, per Toulson J.; *Re National Irish Bank Ltd; Director of Corporate Enforcement v Seymour* [2007] I.E.H.C. 102; unreported, Murphy J., March 20, 2007 (argument that director owed a fiduciary duty to the Revenue Commissioners rejected).
[70] See R. Grantham, "The Judicial Extension of Directors' Duties to Creditors" [1991] J.B.L. 1.

3.4 The time span of the duties

It is commonly understood that directors' duties arise on appointment and generally end on termination of appointment. However, the duty to avoid conflicts of interest is often regarded as continuing to apply post-termination.[71]

3.5 Application of the duties to de facto and shadow directors

Shadow directors have not been regarded as having duties and obligations which are co-extensive with those of their *de iure* counterparts. The Companies Acts 1963 to 2012 do not on their face subject shadow directors to the same duties as *de iure* directors. Rather, they reveal a selective legislative attitude to shadow directors – they are expressly included within the regulatory net in certain instances. Section 27 of the 1990 Act provides a definition of a shadow director for the purposes of Part III of the Act of 1990 headed "Transactions Involving Directors" which deals with substantial property transactions involving directors and connected persons, loans and related transactions to directors and connected persons and duties of disclosure in relation to transactions involving directors and connected persons. The civil liability provisions for fraudulent and reckless trading also apply to shadow directors.[72] Shadow directors may be the subject of a restriction[73] or disqualification order.[74]

There have been mixed views on whether shadow directors are subject to the equitable and common law duties of directors. In *Ultraframe (UK) Ltd v Fielding*[75] Lewison J. envisaged that in certain circumstances shadow directors may have duties imposed on them:

> "The indirect influence exerted by a paradigm shadow director who does not directly deal with or claim the right to deal directly with the company's assets will not usually, in my judgment, be enough to impose fiduciary duties upon him; although he will, of course be subject to those statutory duties and disabilities that the Companies Act creates. The case is the stronger where the shadow director has been acting throughout in furtherance of his own, rather than the company's, interests. However, on the facts of a particular case, the activities of a shadow director may go beyond the mere exertion of indirect influence."[76]

The issue was left open in the UK by the Companies Act 2006. There has been no judicial guidance on the point in this jurisdiction. However, it is notable that in the Irish Company Law Review Group's General Scheme of Companies Consolidation and Reform Bill, Part A5 "Duties of Directors," which places the non-statutory duties on a statutory footing, is expressed to apply, with certain modifications, to shadow directors.[77]

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[71] See generally D. Ahern, *Directors' Duties: Law and Practice* (Round Hall, 2012) at paras 7-58 to 7-64.
[72] Companies Act 1963, s.297A(10) (as inserted by Companies Act 1990, s.138) defines "officer" as including a shadow director.
[73] Companies Act 1990, s.149(5). Corporate shadow directors have been held to be excluded from s.150 of the Companies Act 1990: *Re Worldport (Ireland) Ltd (In Liquidation)* [2008] IESC 68, [2012] 1 I.L.R.M. 241.
[74] Section 159 of the Companies Act 1990 defines "officer for the purposes of the disqualification regime in s.160 as including a shadow director.
[75] [2005] EWCA 1638 (Ch).
[76] *ibid*. at para.[1289].
[77] General Scheme of Companies Consolidation and Reform Bill (2007), Part A5, Head 3.

Despite their irregular assumption of office, the courts have treated de facto directors who assume the role but have not been properly appointed as subject to the same duties as directors who have been validly appointed.[78] Therefore, for example, if they do not properly manage the company's affairs they are liable to the company for loss suffered in the same way as true directors.[79]

In *Re CB Readymix Ltd (In Liquidation); Cahill v Grimes*,[80] Murphy J., relying on the persuasive authority of *Re Lo-Line Electric Motors Ltd*,[81] gave obiter recognition to the concept of a *de facto* director and to the applicability of the disqualification provisions of s.160 of the Companies Act 1990 to *de facto* directors. Subsequently, in *Re Lynrowan Enterprises Ltd*[82] *de facto* directors were held to come within the restriction regime in s.150 of the Companies Act 1990.[83]

The Company Law Review Group's General Scheme of the Companies Consolidation and Reform Bill contains particular provisions dealing with *de facto* directors.[84] The draft provisions create a statutory recognition of de facto directors for the first time and treat de facto directors as subject to the same duties as formally appointed directors. It is further provided by way of a saving provision that "a person shall not be a de facto director by reason only of the fact that he gives advice in a professional capacity." This reflects case law which has inclined towards the view that advisers who do not participate in decisionmaking as part of the governance of the company will not be regarded as de facto directors. The draft provision also subjects *de facto* directors to the duty of disclosure of interests in contracts contained in s.194 of the Companies Act 1963.

[78] *Re Canadian Land Reclaiming and Colonizing Co* (1880) 14 Ch. D. 660; *Re First Class Toy Traders Ltd; Gray v McLoughlin* unreported, High Court, Finlay Geoghegan J., July 9, 2004; *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch); *Shepherds Investments Ltd v Walters* [2007] 2 B.C.L.C. 202.
[79] *Morris v Kanssen* [1946] A.C. 459.
[80] [2002] 1 I.R. 372.
[81] [1988] 2 All E.R. 692.
[82] Unreported, High Court, O'Neill J., July 31, 2002.
[83] See also *Re First Class Toy Traders Ltd; Gray v McLoughlin* High Court, unreported, Finlay Geoghegan J., July 9, 2004.
[84] General Scheme of Companies Consolidation and Reform Bill, Part A5, Head 4.

4 LIABILITY FOR BREACH OF DUTY

4.1 The duty of care

The composite duty of care, skill and diligence is both an equitable and a common law duty.[85]

The requirements tend to be broadly expressed. Expectations of directors have, however, shifted considerably over time. It can be said that of the non-statutory duties those relating to care skill and diligence have changed the most. It may be argued that it is not the role of law to intervene in the affairs of companies by second-guessing difficult decisions made by directors; decisions, moreover, which inevitably involve some element of risk. As a result, the courts have been reluctant to determine what is and what is not a reasonable test of such matters. This is irrespective of whether or not the test is objective or subjective. Instead, the courts have employed common sense and have tried to conform to what is best in informed thinking on these matters. The courts do take account in any given case of each director's knowledge and experience. The courts accept that every company context is different. In recent years, there has been a discernible shift in approach by the Irish courts towards the inclusion of greater objectivity in the standard of care which directors must meet. This in turn reflects a heightened public focus on issues of corporate governance.

The objective approach has involved a move away from the early laissez faire judicial approach to the duty of care, skill and diligence. In the early twentieth-first century, corporate life in Ireland is composed both of professional directors of large private and public companies and their advisors (such companies being limited in number) and of a vast number of small ''one-man companies'' or ''quasi- partnerships'' whose shareholder directors have opted for the advantages offered by limited liability without having a deep understanding of the legal burdens of directorship. Despite the fact that directors come from a large variety of backgrounds, the courts have frequently sought to bring an objective standard to questions when discussing the duty to exercise care, skill and diligence, rather than to rely on subjective criteria. This reflects the fact that business direction is no longer confined to people from a narrow social category, gentlemen amateurs of a kind, as was the case in previous times, but is now far more meritocratic in nature.

The shift in Irish judicial thinking has followed the thinking in England which in turn has trailed developments in Australia where the courts have been more dynamic in adapting the application of directors' duties to modern business life. There have been watershed decisions. *Dorchester Finance Co Ltd v Stebbing*[86] was the beginning of the end to the protective approach on the part of the judiciary to token and part-time directors who did not take their duties seriously.

The *Barings* case[87] which was seminal in the development of judicial thinking on care, skill and diligence, has been influential in the Irish courts. The Barings standard is more objective in nature

[85] *Permanent Building Society (In Liquidation) v Wheeler* (1994) 14A.C.S.R. 109 at 156, per Ipp J.;*Base Metal Trading Ltd v Shamurin* [2004] EWCA Civ 1316, [2005] i All E. R. (Comm) 17, para 19, per Tuckey L. J.; *Re Tralee Beef and Lamb Ltd (In Liquidation); Kavanagh v Delaney* [2004] IEHC 139, [2005] 1 I.L.R.M. 34 at 41, per Finlay Geoghegan J.
[86] [1989] B.C.L.C. 498
[87] *Re Barings Plc (No5), Secretary of State for Trade and Industry v Baker* [1999] 1B.C.L.C..433

than the traditional approach. Directors are treated differently from other professionals who are subject to the duty of care. As there are common entry requirements to the professions, it is possible in these instances to provide for a purely objective standard of care. On the other hand, in the case of directors, entry controls are minimal and not qualitative in nature. It remains the case that the duty of care applicable in any given instance must allow for individual circumstances. Factors to be considered in an appraisal by the court would include the size of the company, the type of director and his or her experience and qualifications, the type of duties undertaken and the remuneration of the director in question. Nevertheless, the standard is now clearly objective: directors have a duty actively to ensure that they are well informed in relation to their role and to that of the business.

The *Barings* approach to delegation and monitoring has received attention in Irish case law, most commonly in case law concerning the restriction of directors following a company entering insolvent liquidation but also in disqualification cases against bank management.[88] In *Re Vehicle Imports Ltd*[89] Murphy J approved the *Barings* proposition that while directors were 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 the competence and integrity of their staff to a reasonable extent, the exercise of the power of delegation did not absolve a director from the duty to supervise the discharge of the delegated functions. These matters can introduce complications; what is operative in a large company is likely to be very different to that operating in a small concern. MacMenamim J. recognised this in *Re Cooke's Events Co Ltd (In Liquidation); Kavanagh v Cooke*[90] where he stated:

> ‘‘Issues such as delegation which may have a significant bearing in the defence of the activities of directors in larger enterprises can hardly be seen in the same light in this small company where the managing director either knew, must have known, or ought to have known, any relevant matter regarding the conduct of the company's affairs and its overall solvency.’’[91]

Mac Menamim J. considered that Mr Cooke could not but have been aware of the level of indebtedness of the company. Mr Cook became the subject of a restriction order.

In *Re Gasco Ltd (In Liquidation)*[92] McCracken J. stated that when considering the application of the restriction regime in s.150 of the Companies Act 1990 to individual directors, regard must be had to the management discipline which was the source of the manager's expertise and frequently determined his ensuing duties. This did not mean that the director could disclaim responsibility altogether on the basis that financial matters, for example, were the responsibility of another director. It remained to be considered, however, whether it was or was not responsible behaviour for one director to rely on the expertise and good judgment of another. A director who relied on his co-directors ‘‘with an optimism that was certainly not justified, but which perhaps was understandable’’ was, however, held to have acted honestly and responsibly. In *Capital Auto Group Ltd (In Voluntary Liquidation); Foster v Swords*[93] it was considered irresponsible for one director to allow his co-director to write cheques on his sole signature without any monitoring.

[88] See *eg Re National Irish Bank Ltd; Director of Corporate Enforcement v Lacey* [2011] IEHC 172.
[89] Unreported, High Court, Murphy J.,November 23, 2000.
[90] [2005] IEHC 225, [2006] I.L.R.M. 191.
[91] [2005] IEHC 225, [2006] I.L.R.M. 191 at 208.
[92] Unreported, High Court, McCracken J.,February 5, 2001.
[93] [2005] IEHC 434; unreported, High Court, Peart J.,December 21, 2005.

The Irish courts have embraced the *Barings* propositions as applicable when considering restriction applications and disqualification applications against directors. This trend began with *Re Vehicle Importers Ltd.*[94] Nevertheless, in *Re Tralee Beef and Lamb Ltd (In Liquidation); Kavanagh v Delaney* the Irish Supreme Court cautioned against applying *Barings* in a one-size-fits-all manner, Hardiman J stated:

> "The position of a highly paid executive director of a vast bank may be of limited use in considering the common law duties of a non-executive director... of a small company.[95]

It is useful to link the propositions in *Barings* with s.214 of the Insolvency Act 1986 (UK), which is now reflected in s.174 of the UK Companies Act 2006. The Irish courts have never had the opportunity to consider the merits of the s.214 hybrid test adapted by the English judiciary to update directorial standards. Irish law does not have a similar provision. There has not been an opportunity for a modern Irish judicial reappraisal of the mostly subjective approach of *Re City Equitable Fire Insurance Co Ltd* as directors' conduct usually only arises for consideration in relation to statutory provisions rather than in relation to direct consideration of the common law and equitable duties of directors.

Breach may lead to either equitable compensation or the common law remedy of damages. Equitable compensation is a remedy which is available in respect of breaches of any of the equitable duties owed by directors to the company.[96] Thus a company director may be held personally liable to pay equitable compensation to a company where loss suffered by the company is attributable to his or her breach of duty.[97] In some circumstances, a statutory remedy may apply *eg* in relation to failure to secure the company's compliance with the Companies Acts, failure to keep proper books of accounts or reckless trading.

Like its common law equivalent, damages, equitable compensation is fault-based in nature and involves a director being made liable for the harm caused by a breach of duty owed to the company.[98] Equitable compensation is essentially restitutionary in nature. It is designed to put the company in the position it would have been in if the breach had not occurred. Although a cause of action accrues as soon as a director acts in breach of duty owed to the company, compensation is assessed at the date of judgment rather than an earlier date.[99]

In order to claim equitable compensation, as well as proving that the director was in breach of duty, a company must prove a causal link between the breach and the loss suffered.[100] Therefore if a company can prove a breach of directors' duty but not that it has suffered loss as a result of that breach, it will be unable to recover equitable compensation. A company must establish a link between

[94] *See also Re National Irish Bank Ltd; Director of Corporate Enforcement v Seymour* [2007]IEHC 102; unreported, High Court, Murphy J., March 20, 2007; *Re National Irish Bank Ltd; Director of Corporate Enforcement v Brennan* [2008] IEHC132; unreported , High Court, Murphy J., April 22, 2008.
[95] [2008] 3 I.R. 347, 360, [2008] 2 I.L.R.M. 420.
[96] In cases where a director's breach results in profit to the director or a vehicle controlled by him or her, the company can elect between an account of profits and equitable compensation as a remedy: *CMS Dolphin Ltd v Simonet* [2001] 2 B.C.L.C. 704. This election will generally be guided by which remedy is likely to lead to a greater amount being recovered by the company.
[97] This is analogous to the duty on trustees to restore trust property lost through breach of trust: *Re Lands Allotment Co* [1894] 1 Ch. 616; *Nocton v Lord Ashburton* [1914] A.C. 932.
[98] *Target Holdings Ltd v Redferns* [1995] 3 All E.R. 785.
[99] *ibid*.
[100] *Re Miller's Deed Trusts* (1978) 75 L.S. Gaz. 454; *Nestle v National Westminster Bank Plc* [1994] 1 All E.R. 118; *Target Holdings Ltd v Redferns* [1995] 3 All E.R. 785.

the compensation sought and the loss caused by the harm.[101] There is a requirement to prove that the breach caused the loss or that the loss would not have occurred but for the breach.[102]

Where there has been a breach of a director's common law duty of care, skill and diligence, damages can provide a remedy to the company for loss suffered. It must be shown that the defendant director's wrongful act caused the damage complained of. It is a prerequisite to establish a sufficient causal link between the breach of duty by the director and the loss suffered by the company. Where the breach is one of omission rather than commission, it is necessary to establish that the loss would have been prevented by the director complying with the relevant duty.[103] Damages are awarded to put the plaintiff company in the position it would have been in had there been no breach of directors' duties.[104] If no loss is sustained by the company as a result of a breach of duty by a director, any damages awarded are likely to be nominal and will simply serve the function of confirming that a breach has occurred.[105]

The distinction between the common law remedy of damages and equitable remedies remains important because while a common law remedy is given as a matter of right once breach is proven, equitable remedies are discretionary in nature. Common law claims for damages have traditionally been subject to stricter rules on remoteness of damage, foreseeability and causation than claims for equitable compensation.[106] It seems likely that in the future there may be a judicial assimilation of the common law rules on causation, remoteness of damage and foreseeability within the sphere of equitable compensation. Indeed, in *Mothew v Bristol & West Building Society*,[107] Millett J. noted obiter that it was simply a product of history that equitable compensation is provided as a remedy rather than damages. He therefore suggested that there was no reason in principle why the common law rules concerning causation, remoteness of damage and measure of damages should not be applied by analogy to equitable compensation.[108] The historical origins of equitable compensation would also appear to rule out the application of a duty to mitigate loss or the award of punitive or exemplary compensation. However, should a court revisit the merits of the distinctions between common law damages and equitable compensation, it is possible that these distinctions may be cast aside.

4.2 Duty of loyalty

The duty of loyalty can be regarded as comprising the duty to act in the best interests of the company, the duty to act for proper purposes and the composite duty to avoid conflicts of interest and secret profits.

In the leading case of *Re Smith and Fawcett Ltd*[109] where Lord Greene M.R. stated that directors "… must exercise their discretion *bona fide* in what they consider – not what a court may consider – to be

[101] *Target Holdings Ltd v Redferns* [1995] 3 All E.R. 785. In *Swindle v Harrison* [1997] 4 All E.R. 705 equitable compensation was not awarded for breach of duty because it was not established that the breach had caused the loss suffered.
[102] Persuasive authorities in a trust law context include *Nestle v National Westminster Bank Plc* [1994] 1 All E.R. 118 and *Target Holdings Ltd v Redferns* [1995] 3 All E.R. 785.
[103] *Bishopsgate Investment Management Ltd (In Liquidation) v Maxwell (No. 2)* [1994] 1 All E.R. 261; *Re Continental Assurance Co of London Plc (No. 4); Singer v Beckett* [2007] 2 B.C.L.C. 287.
[104] *Livingstone v Rawyards Coal Co* (1880) 5 App. Cas. 25.
[105] *Luna Park (NSW) Ltd v Tramways Advertising Pty Ltd* (1938) 61 C.L.R. 286.
[106] This reflects the trust law origins of the principles of equitable compensation.
[107] [1998] Ch. 1.
[108] *ibid*. at 17.
[109] [1942] 1 All E.R. 542.

in the interests of the company…."[110] This subjective test statement was quoted with approval by the Irish High Court in *Banfi Ltd v Moran*.[111]

The judicial test applied for assessing improper purposes was formulated by Lord Wilberforce in *Howard Smith Ltd v Ampol Petroleum Ltd.*[112] The case is authority for a two step approach for determining whether, objectively viewed, on balance, the exercise of the power was a proper one. Once the nature of the power is determined,[113] it is necessary to determine what was the substantial purpose behind the exercise of a particular power, having regard to the subjective beliefs of the directors and their judgment in relation to matters of management. This is an objective test coloured by objectively ascertained subjective motives. In *Nash v Lancegaye Safety Glass (Ireland) Ltd*[114] it was emphasised that it is the object that is important not the likelihood of achieving it.

In order to protect the company's interests, the equitable duty on directors to avoid unauthorised conflicts of interest and secret profits places limits on directors engaging in competing and other opportunistic activity. In line with recent judicial practice, these distinct but closely allied branches of duty are referred to as the 'no conflict rule' and the 'no profit rule', and collectively as the 'no conflict-no profit rules. [115]

English cases establishing a strict prophylactic approach to conflicts of interest[116] have persuasive force in Ireland. At the centre of the no profit rule is the policy that a director must not make a secret profit through the use of opportunities which have arisen in the course of his or her management of the company's affairs. It is irrelevant whether or not the acts of the director in any given instance can be classified as proper or improper. The relevant criterion is whether or not the gain was made by the director during his period of directorship in the company. This is seen in *Parker v McKenna*,[117] a case that has persuasive authority in Ireland, where the court considered how to treat the issue of the directors taking up shares in the company.

The no conflict-no profit rules have both an internal and external application. The internal aspect requires that the director should not have an unauthorised personal interest in transactions with the company. In cases where the transaction does not pass this test, it may be avoided by the company.[118] The rule and the associated right of rescission do not require an enquiry into the fairness or otherwise of the terms which have been contracted. Even if the terms would have been no less favourable to the company to that of an instance where the director was not involved, the company still has a right to avoid the contract.

[110] *ibid.* at 543. See also *Shuttleworth v Cox Bros & Co* [1927] 2 K.B. 9.
[111] [2006] IEHC 257; unreported, Laffoy J., July 20, 2006.
[112] [1974] A.C. 821.
[113] A very broad power will be limited by the requirement to exercise it in the interests of the company: *Re Smith & Fawcett Ltd* [1942] 1 All E.R. 542, 545, per Lord Greene M.R.
[114] (1958) 92 I.L.T.R. 11.
[115] The use of the term 'rule' rather than 'duty' reflects doubts among expressed by the courts and legal scholars as to whether the no conflict-no profit rules should be regarded as an equitable disability rather a duty. The only practical implication would appear to have been in relation to the appropriate statutory limitation period for instituting proceedings but the relevance of the duty/disability distinction in this context was dismissed by the Court of Appeal in *Gwembe Valley Development Co Ltd (In Receivership) v Koshy (No. 3)* [2003] EWCA Civ 1048, [2004] 1 B.C.L.C. 131.
[116] *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq. H.L. 461; *Regal (Hastings) Ltd v Gulliver* [1942] 1 All E.R. 378; *Re Allied Business and Financial Consultants Ltd; O'Donnell v Shanahan* [2009] EWCA Civ 751, [2009] 2 B.C.L.C. 666.
[117] (1874) 10 Ch, App.96.
[118] *Hopkins v Shannon transport Systems Ltd* (1972) [1963-1999] Ir. Co. Law Rep. 238.

The Irish Parliament (the Oireachtas) has seen fit to supplement legislatively the internal aspect of the no conflict-no profit rules. Part 3 of the Companies Act 1990 represents a clear policy decision to tighten the regulation of directors. Part 3 was designed ''to deal with the recognisable situations where a company director might be tempted to put his personal interests before that of the company.''[119] Section 29 of the Companies Act 1990 has also put in place an additional framework in respect of substantial property transactions between a company and its director or directors or qualifying connected persons. In addition, the introduction of the concept of a connected person in this Act has allowed for a more sophisticated approach.[120] This last amendment has filled the gap in the existing non-statutory rules: these rules did not extend much beyond the director or a business vehicle in which he or she was interested.

The internal no profit-no conflict rules are also supplemented by s.31 of the Companies Act 1990 (as amended by Pt 9 of the Company Law Enforcement Act 2001). Section 31 regulates loans and related transactions (quasi-loans, credit transactions, guarantees and the provision of securities) by companies to directors and connected persons, and in the case of guarantees and security it is necessary that a special resolution be passed.

Insider dealing in quoted securities on the basis of non-publicly available information was first regulated by Pt V of the Companies Act 1990. The legislation provided for both criminal and civil liability. In *Fyffes Plc vDCC Plc*[121] Laffoy J. determined that a director who uses confidential corporate information to make a profit from dealing in the company's securities could be liable to account for such profit.[122] Laffoy J. also referred to the difficulty in such a case of ensuring that the ''equitable remedy sat comfortably with the statutory remedies.''[123]

The external aspect of the no conflict-no profit rules relates to a director using his or her position for personal advantage when dealing with external parties. The Irish courts have followed the *Regal (Hastings) Ltd v Gulliver* decision, although there has been a measure of unease with it, given the windfall profits awarded to *Regal(Hastings)*.[124] It was cited with approval in *Hopkins v Shannon Transport Systems Ltd*[125] and *Fyffes Plc v DCC Plc*.[126]

It is uncertain how corporate opportunity cases will be treated in this jurisdiction, given the lack of judicial decisions in this area. In *Fyffes Plc v DCC Plc* Laffoy J. accepted that liability for breach of fiduciary duty could arise irrespective of whether the company could have made a profit. This may indicate that a capacity approach to directorial initiative would be preferred, if the issue were to arise for direct consideration in an Irish case.[127] e persuasive value of the English cases of *Bhullar v Bhullar*[128] and *Re Allied Business and Financial Consultants Ltd; O'Donnell v Shanahan*[129] would be supportive of this interpretation. On this approach, it may also be that an opportunity learned of in a

[119] See the explanatory memorandum to the Companies Bill 1987.
[120] Defined in s26(1) of the Companies Act 1990 (as substituted by s76(a) of the company Law Enforcement Act 2001.
[121] [2005] IEHC 477, [2009] 2 I.R. 417. .
[122] See also *Diamond v Oreamuno* (1969) 248 N.E. 2d 910; *Walsh v Deloitte and Touche Inc* [2001] UKPC 58.
[123] [2007] IESC 36; unreported, Supreme Court, July 27, 2007.
[124] [1942] 1 All E.R. 378.
[125] (1972) [1963-1999] Ir.Co..Law.Rep.238
[126] [2005] IEHC 477, [2009] 2 I.R. 417.,
[127] D. Ahern *Directors' Duties: Law and Practice* 1st edn .Thomson Reuters, 2009 at para.7.40.
[128] [2003] EWCA Civ 424, [2003] 2 B.C.L.C. 241.
[129] [2009] EWCA Civ 751, [2009] 2 B.C.L.C. 666.

private capacity which is not in the company's direct line of business would still need to be disclosed.[130]

The relevant English cases have impacted significantly on Irish judicial thinking. In recent years, the English courts have appeared to extend the breadth of the disclosure obligation beyond the subject-matter of misconduct to include a duty to disclose anything of even marginal interest to the company. Parker L.J.'s view in *Bhullar v Bhullar*[131] was that a more extensive duty of disclosure could arise in certain cases. In particular, a duty to communicate information to the company would be triggered where a director was aware of the existence of an opportunity which it was ''relevant for the company to know.''[132] Such language can be interpreted very broadly; *Bhullar* even allows for the possibility that the circumstances might be of interest to the company, but not of direct interest to a director making the declaration. Parker L.J.'s pronouncements have been subject to criticism both in terms of their scope and their legal foundation.[133]

As in English law, in Irish law, not all dealings that come within the no conflict-no profit rules are prohibited; only those that are unauthorised. It is possible to get the informed consent of the company in relation to acts which would otherwise breach these rules. There are two means of authorising what would otherwise constitute unauthorised conflicts and profits in breach of duty. The first method is contractual exclusion;[134] the second, approval obtained on an individual basis after full and frank disclosure by the director of the relevant circumstances[135] in the appropriate manner.[136] Although the point has not been the subject of a direct ruling, there is a suggestion in *Hopkins v Shannon Transport Systems Ltd*[137] that disclosure should be made to an independent board of directors. However, if model Reg.7[138] is adopted by a company in its articles of association, this contemplates a conflicted director being able to vote. If a director in such a position does vote, they will be subject to the duty to act in the best interests of the company rather than their own interests.

In relation to contractual exclusion, judicial recognition that the extent of a general duty owed by one party to another may be modified by contract has allowed for instances where actions may be authorised.[139] The articles of association may specifically authorise the directors to enter into certain types of contracts with the company or to have an interest in contracts which the company enters into with third parties.[140] A provision in the articles can enable a director to be a member of another company with which the company is contracting provided that there is full disclosure and that the

[130] See further D. Ahern, "Guiding Principles for Directorial Conflicts of Interest: *Re Allied Business and Financial Consultants Ltd; O'Donnell* v *Shanahan*" (2011) 127 *Modern Law Review* 596.
[131] [2004] EWCA Civ 424, [2003] 2 B.C.L.C.241.
[132] [2004] EWCA Civ 424, [2003] 2 B.C.L.C.241 at para.41.
[133] H.C. Hirt, 'The Law on Corporate Opportunities in the Court of Appeal: Re Bhullar Bros Ltd'' [2005] J.B.L.669 at 677-678; D. Ahern, "Guiding Principles for Directorial Conflicts of Interest: *Re Allied Business and Financial Consultants Ltd; O'Donnell* v *Shanahan*" (2011) 127 *Modern Law Review* 596.
[134] *Kelly v Cooper* [1993] A.C. 205; *Henderson v Merritt Syndicates Ltd* [1995] 2 A.C.145. Cases relating to relaxations contained in the articles of association include *Movitex Ltdv Bulfield* [1988] B.C.L.C.104; *Wilkinson v West Coast Capital* [2005] EWHC 3009 (Ch). Contractual exclusion also commonly appears in director's service contracts and shareholder agreements.
[135] On the manner of full and frank disclosure, see *Regal(Hastings) Ltd v Gulliver* [1942 1 All E.R.378.
[136] In the absence of statutory guidance in Ireland, there has been some controversy as to whether the appropriate forum for consent is the board of directors or the company in general meeting. A case that has persuasive significance in this jurisdiction is *Queensland Mines Ltd v Hudson* (1978) 52 A.J.L.R. 399. It lent support to the view that the board is the appropriate forum and this view has often since prevailed in other cases. See further G. R. Sullivan, ''Going it Alone Queensland Mines v Hudson''(1979) 42 M.L.R. 711.
[137] (1972) [1963-1999] Ir. Co. Law Rep. 238.
[138] Companies Act 1963, First Schedule, Table A, Part I.
[139] *Kelly v Cooper* [1993] A.C. 205; *Henderson v Merrett Syndicates* [1994] 3 All E.R. 506.
[140] *Motivex Ltd v Bulfield* [1988]B.C.L.C. 104; *Wilkinson v West Coast Capital* [2005] EWHC 3009 (Ch).

director does not vote on matters relating to the relevant contract[141] The effect in this jurisdiction of including model Regulation 85[142] in a company's articles of association is to enable a director to hold another office in conjunction with his existing office of director and to remove contracts entered into by the company from the threat of avoidance. It also removes the requirement to account for profits thereby realised. The no conflict-no profit rules may also be contractually limited in a director's service contract with the company or in a shareholders' agreement which is expressed to take precedence over the company's articles of association.[143] Any prearranged alteration of the company's articles of association is carefully weighed by the courts. In addition, any such displacement will need to comply with board disclosure requirements in relation to self-dealing in s.194 of the Companies Act 1963.[144]

Section 194 provides for the statutory duty of disclosure applicable to directors involved in internal contracting with the company. This supplements the equitable duty of disclosure. A case involving s.194 is *Re Xnet Information Systems Ltd (In Voluntary Liquidation); Stafford v Higgins*.[145] In that case, the two executive directors of the company who were also its sole shareholders purchased premises with a view to leasing the property back to the company. This arrangement involved complex financial arrangements. Substantial loans were obtained from the company without formally seeking the approval of the board of directors. Finlay Geoghegan J. held that directors could not be regarded as acting responsibly in entering into significant financial transactions with the company without bringing the matter to the attention of the board. A declaration of restriction was made against each director.

The account of profits remedy will be relevant where a director has profited from his position by breaching the no conflict-no profit rules by making a secret profit, for example, by exploiting what can be classed as a corporate opportunity. The profits within the scope of an account consequent on a director's breach of duty have been variously defined as profits made as a result of the breach of duty and profits from a transaction which has involved a breach of duty. As well as direct profits, a resulting increase in the value of a shareholding held by a director may fall within the scope of an account.[146] A director in breach of fiduciary duty is not liable to account for profits which are not attributable to the breach.[147] As an alternative equitable compensation may be claimed for breaches of the no conflict-no profit rules.[148]

Rescission (avoidance of transactions affected by breach) may be an appropriate remedy where a contract has been entered into which is tainted by a breach of duty provided that *restitutio in integrum* is possible.[149] This applies to contracts entered into in breach of the duty to act bona fide in the best interests of the company and for proper purpose, and the duty to avoid conflicts of interests and secret profits. Where a director's contract with the company involves an unauthorised conflict of interest, the contract is voidable at the company's instance and can be set aside by the company irrespective of the fairness of the terms or whether any loss has been suffered by the company.[150]

[141] *Transvaal Lands Co v New Belgium (Transvaal) Land and Development Co* [1914] 2 Ch 488 (company's articles providing for disclosure.
[142] Companies Act 1963, First Schedule, Table A, Part I.
[143] See D. Ahern *Directors' Duties: Law and Practice* Round Hall Dublin 2009 at Chapter 7 and *Wilkinson v West Coast Capital* [2005] EWHC 3009 (Ch).
[144] *Hopkins v Shannon Transport Systems Ltd* (1972) [1963-1999] Ir.Co.Law Rep.238.
[145] Unreported, High Court, Finlay Geoghegan J.,May 6, 2004.
[146] *Gwembe Valley Development Co Ltd (In Receivership) v Koshy (No. 3)* [2003] EWCA Civ 1048, [2004] 1 B.C.L.C. 131, para.[137], per Mummery L.J.
[147] *Murad v Al-Saraj* [2005] EWCA Civ 959, paras[77]-[79], [85].
[148] See e.g. *CMS Dolphin Ltd v Simonet* [2001] 2 B.C.L.C. 704.
[149] *Erlanger v New Sombrero Phosphate Co* (1873) 3 App. Ca, 1218; *Bentinck v Fenn* (1887) L.R. 12 App. Cas. 652; *Burland v Earle* [1902] A.C. 83; *Armstrong v Jackson* [1917] 2 K.B. 822; *Gray v New Augurita Porcupine Mines* [1952] 3 D.L.R. 1; *Craven Textile Engineers Ltd v Batley Football Club Ltd* [2001] B.C.C. 679.
[150] *Aberdeen Railway Co v Blaikie Bros* [1843-1860] All E.R. Rep. 249; *Movitex Ltd v Bulfield* [1988] B.C.L.C. .104.

4.3 Exemptions and limitations

Section 200(1) of the Companies Act 1963 declares void any provision contained in a company's articles of association or any contractual provision which purports to exempt a director or indemnify him or her against liability "in respect of any negligence, default, breach of duty or breach of trust" in relation to the company.[151]

It is a key principle of the law applicable to directors (who act as fiduciaries) that the company may ratify a breach which has taken place.[152] It is also possible to pre-authorise or release such a person in advance to engage in conduct which would otherwise be a breach of duty.[153]

Section 391 of the Companies Act 1963 deals with relieving a director from liability for breach of duty.[154] Section 391(1) provides for a statutory judicial discretion to relieve a director from liability for "negligence, default, breach of duty or breach of trust"[155] provided that the court is of the view that the director "has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought to be excused".

It is possible in certain circumstances for a company to agree to indemnify directors against the costs of defending proceedings instituted against them. This is an area where there has been a considerable shift in policy over time. Originally s.200 of the Companies Act 1963 contained a prohibition on indemnifying directors.[156] For a long time s.200 was out of step with the common commercial practice of obtaining directors' and officers' insurance ("D&O insurance") to help meet the gap which may occur where a director's resources are insufficient to compensate the company for the breach. However, following the CLRG's recommendation that D&O insurance be facilitated, s.200 was amended by s.56 of the Companies (Auditing and Accounting) Act 2003.[157] The amended provision maintains the general prohibition on liability exemption but expressly permits a company to obtain D&O insurance.

4.4 Insurance against liability

A statutory amendment in 2003 has facilitated the market in D&O insurance.[158] Section 200(2) of the Companies Act 1963 (as amended) states "[n]otwithstanding subsection (1), a company may

[151] On the effect of such a provision see C. Passmore, "Directors' Indemnities" (1995) 16 Co. Law. 243; L.S. Sealy, "Company-Directors' 'Duties' and Exempting Articles" [1987] 46 C.L.J. 217.
[152] *Bamford v Bamford* [1970] 1 Ch. 212.
[153] *NZ Netherlands Society 'Oranje' Inc v Kuys* [1973] 2 All E.R. 1222.
[154] This mirrored legislative developments in the UK in s.448 of the Companies Act 1948 (UK) arising from recommendations in *Report of the Company Law Amendment Committee* (the Reid Committee Report) Cmnd 3052 (London: HMSO, 1906), para.24. See further R. Edmunds and J. Lowry, "The Continuing Value of Relief for Directors' Breach of Duty" (2003) 66 M.L.R. 195.
[155] The incongruity of the use of "breach of trust" given that the directors are not trustees is attributable to the provision's antecedent, s.32 of the Companies Act 1907, which largely borrowed from the trustee liability provision in s.32 of the Judicial Trustees Act 1896: P. Koh, "An Issue of Absolution – Section 391 of the Companies Act" (2003) 15 S.Ac.L.J. 306, 307.
[156] It was, however, permissible for a company to indemnify a director against his or her costs in relation to proceedings which were successfully defended or in relation to a successful application for relief under s.391 of the Companies Act 1963: Companies Act 1963, s.200(b).
[157] Section 56 was commenced on April 6, 2004 pursuant to the Companies (Auditing and Accounting) Act 2003 (Commencement) Order (S.I. No. 132 of 2004).
[158] Section 200 of the Companies Act 1963 (as amended by section 56 of the Companies (Auditing and Accounting) Act 2003.

purchase and maintain for any of its officers or auditors insurance in respect of any liability referred to in that subsection." The liabilities referred to in s.200(1) are "any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust".

4.5 Consequences of Liability

The remedy of damages for breaches of care, skill and diligence has been discussed earlier.

Secondary liability for knowing receipt may attach to a third party who receives trust property[159] or its proceeds.[160] This remedy can be useful where a personal claim against a director is unlikely to cover the loss suffered by the company and corporate property has been passed on by a director in whole or in part to a third party. The main issue in relation to imposing a constructive trust is the requisite knowledge of the breach that is required by the third party who receives corporate property. Actual knowledge of the breach will always suffice but the courts have also been prepared to found liability for knowing receipt on constructive knowledge.[161]

The issue of avoiding transactions subject to breach was discussed earlier.

4.6 Duration of liability

Liability is generally understood to cease on resignation, with the exception of the duty to avoid secret profits where post-termination behaviour is tainted by prior breaches of duty. The Irish courts have not had the opportunity to rule on the matter but English corporate opportunity cases suggest that in certain circumstances the no profit rule can continue to apply to former directors.[162] By contrast, the no conflict rule does not continue to apply to former directors following the loss of their directorial powers.[163]

[159] Or, in the present context, corporate property.

[160] See *Belmont Finance Corporation Ltd v Williams Furniture Ltd(No. 2)* [1980] 1 All E.R. 393; *Baden Delvaux v Société Générale* [1983] B.C.L.C. 325; *Attorney General of Hong Kong v Reid* [1994] 1 All E.R. 1; *El Ajou v Dollar Land Holdings Plc* [1994] B.C.C. 143; *Re Frederick Inns Ltd* [1994] 1 I.L.R.M. 387; *BCCI Ltd v Akindele* [2000] 4 All E.R. 221; *Fyffes Plc v DCC Plc* [2005] IEHC 477; unreported, Laffoy J., December 21, 2005; *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch).

[161] *Re Frederick Inns Ltd* [1994] 1 I.L.R.M. 387.

[162] See Warren J. in *Wilkinson v West Coast Capital* [2005] EWHC 3009 (Ch), [251] and cases cited therein; *Ultraframe (UK) Ltd v Fielding* [2005] EWHC Civ 1638 (Ch), [1309], *per* Lewison J. and *Kingsley IT Consulting Ltd v McIntosh* [2006] EWHC 1288 (Ch), [2006] B.C.C. 865, [51], *per* Terence Mowschenson Q.C.

[163] *Wilkinson v West Coast Capital* [2005] EWHC 3009 (Ch),, [251], *per* Warren J.; *Ultraframe (UK) Ltd v Fielding* [2005] EWHC Civ 1638 (Ch), [1308], *per* Lewison J.

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 The meaning of 'vicinity of insolvency'

Insolvency is understood as the inability of a company to pay its debts as defined by section 214 of the Companies Act 1963. Company insolvencies are governed by the Companies Acts 1963 to 2012, the Rules of the Superior Courts, Orders 74, 75[164] and Order 75A[165] and case law. There are two tests for establishing insolvency:

(a) The 'cash flow' test, which requires showing that the company is unable to pay its debts as they fall due for payment and

(b) The 'balance sheet' test, which depends on showing that the value of the company's assets is insufficient to meet its liabilities, including (for certain statutory purposes) contingent and prospective liabilities.[166]

These separate tests have different applications and implications, depending on the particular statutory provision being applied.

A duty to consider the interests of creditors will displace the duty to act in the interests of the company under Irish law not just where formal insolvency procedures have been activated, but also where there is an entitlement to initiate them.[167] This was established in *Re Frederick Inns Ltd*[168] where Blayney J. stated:

> "Where, as here, a company's situation was such that any creditor could have caused it to be wound up on the ground of insolvency, I consider that it can equally well be said that the company had ceased to be the beneficial owner of its assets with the result that the directors would have had no power to use the company's assets to discharge the liabilities of other companies. Once the company clearly had to be wound up and its assets applied *pro tanto* in discharge of its liabilities, the directors had a duty to the creditors to preserve the assets to enable this to be done, or at least not to dissipate them."[169]

[164] S I 15/1986.
[165] S I 147/1991.
[166] These tests were discussed in *Re Club Tivoli Ltd (in vol liq); Foster v Davis* [2005] IEHC 215, [2006] 1 I.L.R.M. 191.
[167] On this issue see A. Keay, "The Director's Duty to Take into Account the Interests of Company Creditors: When is it Triggered?" (2001) 25 Mon. L.R. 315.
[168] [1994] 1 I.L.R.M. 387.
[169] ibid. at 396. This view has been criticised by Fealy who argues that this reasoning is not sound. His preferred view is that the beneficial ownership of the company's assets is suspended upon the company going into a winding up and that the Supreme Court's innovation of passing the beneficial ownership to the creditors on the company becoming insolvent ignores the fact that the granting of an order to wind up a company is a matter of judicial discretion: M. Fealy, "The Role of Equity in the Winding Up of a Company" (1995) D.U.L.J. (n.s.) 18 at 18.
169 [2002] EWHC 2748 (Ch), [2003] 2 B.C.L.C. 153.

In *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd*[170] where Leslie Kosmin Q.C. (sitting as a deputy judge of the High Court) regarded the creditor consideration principle as applicable when the company is of doubtful solvency or on the verge of insolvency.[171] Given the tenor of the judicial comments quoted above in *Re Frederick Inns*, it is likely that the Irish courts would also extend the duty to consider creditors' interests to 'twilight' cases where a company is in the vicinity of insolvency.

5.2 Change of existing duties

If it is likely that the company will not be able to pay all of its debts, the directors should not improperly prefer one creditor out of the general body of creditors.[172] In *Jones v Gunn*[173] McGuinness J stated that "… where a company is clearly insolvent, even if not in liquidation, the directors owe a fiduciary duty *to the general creditors* and may not make payments which benefit either closely connected companies or themselves personally to the detriment of the general and independent creditors."[174] It does not follow, however, that a company is obliged to close down at the first sight of economic difficulty. Although the directors may have no choice but to recommend placing the company in liquidation and distributing the assets for the benefit of the creditors, this may not always be the case.[175] It may be that by continuing to trade, a more favourable outcome for creditors may be achieved. Where it is reasonable to continue to trade, for example in an effort to complete a contract and generate further revenue, it is unlikely that an Irish court will find the directors responsible for reckless trading[176] or under the restriction regime applicable to directors of insolvent companies.

In *Re USIT World plc*[177] the liquidator expressed concern that the company had traded while it was insolvent on a balance sheet basis. Peart J. recognised that a reasonable and limited effort at trading out of the company's difficulties is not irresponsible. He made the following pertinent comments on the issue:

> "Many companies will experience for many reasons unrelated to the general health of the company, a downturn in profitability over a quarter, two quarters or even three quarters. That in my view does not mean that even where a risk of insolvency downstream is warranted or anticipated, some reasonable effort at rescuing the situation may not be permitted to be undertaken. To attempt to trade out of a difficulty is not an irresponsible act. Care of course must be taken to ensure that effective and realistic steps are taken and that creditors' interests are kept to the fore, rather than that a careless or reckless gamble is taken without proper advice and planning to an achievable end. Some sort of short term emergency fire-fighting must be permitted to take place without those efforts, provided they are reasonable and responsible, from being made. Many companies have survived and prospered after temporary setbacks."[178]

170 [2002] EWHC 2748 (Ch), [2003] 2 B.C.L.C. 153.
171 See also *Re MDA Investment Management Ltd* [2003] EWHC 2748.
172 *Re Swanpool Ltd (In Voluntary Liquidation); McLaughlin v Lannen* [2005] IEHC 341, [2006] 2 I.L.R.M. 217.
173 [1997] 3 I.R. 1.
174 ibid. at 22 (emphasis added).
175 See further D. Ahern, "Directors' Duties in an Economic Downturn: Lessons from the Restriction Regime" (2009) 31 *Dublin University Law Journal* 183.
176 This was recognised in *Re Hefferon Kearns Limited (No. 2)* [1992] 1 ILRM 51.
177 [2005] IEHC 285, unreported, Peart J., August 10, 2005.
178 *ibid.* at 70-71.

In this case it was acknowledged that the fallout of September 11, 2001 had a very large part to play in the company's difficulties since it led to financing being pulled. Furthermore, the directors had taken legal and accountancy advice in relation to its continued trading after September 11. In relation to the facts before him, Peart J stated that "[t]his is not a case where heads were placed in the sand so that problems on the horizon were ignored."[179] For an attempt to trade out of difficulties to be judged irresponsible, there would have to be "some element of recklessness or culpable want of care on the part of a director."[180] He emphasised that it was not sufficient that the directors took decisions that later turned out to be the wrong decisions with the benefit of hindsight.

In the English case of *Re Welfab Engineers Ltd*[181] Hoffmann J. expressed the view that it is not required that directors must act to the best advantage of creditors but simply that the directors should ensure that the company only continues trading if to do so would not leave creditors in a worse position than on liquidation.

There is an issue as to whether a direct duty is owed to creditors once the duty to consider the interests of creditors is triggered or whether it is simply an aspect of the duty to act in the company's interests. The preferred view is that the duty is owed to the company rather than a duty being owed directly to creditors and directly enforceable by them.[182]

5.3 Newly arising duties

There is no express obligation under Irish law on a company and its directors to take any steps to wind-up a company or to put it into examinership (a corporate rescue process in some ways comparable to Chapter 11 in the United States) when a company is insolvent. Indeed, neither insolvency nor trading while insolvent in themselves give rise to criminal or civil liability for directors. It is often only when a company is put into examinership or liquidation that consequences may flow for directors. Where a formal insolvency begins, the conduct of the directors over a given period prior to the insolvency is subject to considerable scrutiny. More particularly, the focus is placed on whether or not the directors have acted honestly and responsibly in the course of their duties.

In the vicinity of insolvency, the directors may recommend to the shareholders that they place the company in voluntary liquidation. The shareholders are not, however, legally obliged to do so. The procedure is governed by ss.265-273 of the Companies Act 1963.

The fact remains, nevertheless, that Irish directors must act responsibly and wisely when the companies they lead are in the vicinity of insolvency. To do otherwise is to risk very severe legal sanctions, such as director restriction under the terms of section 150 of the Companies Act, 1990 and section 56 of the Companies Law Enforcement Act 2001. The restriction regime will potentially apply to all directors of companies which have been placed in insolvent liquidation whose conduct is judged to be dishonest or irresponsible. The seminal judgment is that of *La Moselle Clothing Ltd.*[183] In that case, the court indicated that in determining the responsibility of a director for the purposes of section 150, the court should have regard to the following:

179 *ibid.* at 71.
180 *ibid.*
181 [1990] B.C.L.C. 833.
182 *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 A.C. 187, 217.
183 *La Moselle Clothing Ltd (in Liquidation) v Soualhi* [1998] 2 ILRM 345.

(a) The extent to which the director has or has not complied with any obligations imposed on him by the Companies Acts;

(b) The extent to which his conduct could be regarded as so incompetent as to amount to irresponsibility;

(c) The extent of the director's responsibility for the insolvency of the company;

(d) The extent of the director's responsibility for the net deficiency in the assets of the company disclosed at the date of the winding-up or thereafter; and

(e) The extent to which the director in his conduct of the affairs of the company displayed a lack of commercial probity or want of proper standards.

Trading in the vicinity of insolvency is fraught with difficulty. In many cases, the safest course of action for directors in Ireland when a company has become insolvent is to take steps to put the company into creditors' voluntary liquidation[184]or petition the High Court for the appointment of an examiner (with a view to corporate rescue). The reckless trading provisions in Irish law do not apply during a period when a company is in examinership.[185] If for whatever reason the directors do not want to put the company into either liquidation or examinership or want time to consider the matter, the only absolutely safe course of conduct to adopt is neither to take further credit nor to reduce the assets of the company. If the directors are intent on continuing to trade even while insolvent, they must ensure that no further credit is incurred: suppliers, including utilities, need to be paid in advance. This course of action can only be justified if the continuation of trading is likely to protect, if not increase, the assets which will ultimately be available to creditors in the event that insolvent liquidation ensues.

Although each case will turn on its facts and will depend on matters such as how creditors are affected, while trading for a number of weeks or even months while insolvent may be acceptable, continuing to do so over a number of years is likely to be branded as irresponsible. In *Re Pineroad Distribution Ltd. (in vol. liq.); Stafford v Fleming*[186] Hanna J. regarded the company having traded while insolvent for a period of two years as evidence of irresponsibility and he castigated the directors for having traded for far too long, having regard to the scale of the company's liabilities to the Revenue Commissioners. He said that while the respondents had not acted in a consciously dishonest way, they had acted in a grossly irresponsible way by shutting their eyes to the long standing and increasing debt owed to the Revenue Commissioners in respect of PAYE/PRSI and VAT and continuing to trade far beyond what was reasonable.

184 Companies Act 1963, s251 and ss266-268.
185 Companies Act 1963, s297a (8).
186 [2007] IEHC 55, unreported, Hanna J., March 7, 2007.

6 ENFORCEMENT

6.1 Who has standing to sue?

The Irish company law rules on enforcement of directors' duties mirror those which applied under English law prior to the reforms effected by the Companies Act 2006.[187]

6.1.1 The company as plaintiff

As regards the enforcement of directors' duties, the practical hurdles which exist to bringing directors to account have their source in the company's division of power between directors and shareholders. The rules have their basis in this: the duties are owed to the company rather than individual shareholders.[188] The Irish courts have adopted, as has been the case elsewhere, what is known as the proper plaintiff principle whereby as the harm is done to the company, not the members, it is the company which must bring any action against the directors for breach of duty.

There are two possible ways for a company to decide whether or not to institute proceedings. First, a decision may be made by the directors (where the directors have authority to institute proceedings in the company's name).[189] In some cases it is the board rather than the company in a general meeting which has a right to determine such matters in the company's name. In circumstances where the company's articles of association require a resolution of the directors in order to institute proceedings, case law indicates that it is not possible for one director to take action against another director.[190] Second, a decision may be made by the members (where the members have authority to institute proceedings in the company's name). The members have a choice: they may decide to institute proceedings or they can ratify a decision already made by the director(s). Consequently, if the majority of the members make the decision that it is in the best interests of the company not to seek a remedy against an errant director, this will generally bind the minority.[191] In coming to a decision about whether or not to proceed with an action, the members will need to consider the consequences of having to pay costs, should the action prove unsuccessful. The statute of limitations for actions of this kind is six years.

187 On the Irish enforcement regime see generally D. Ahern, "Directors' Duties: Broadening the Focus Beyond Content to Examine the Accountability Spectrum" (2011) 33 *Dublin University Law Journal* 116.
188 *Percival v Wright* [1902] 2 Ch. 421; *Dawson International Plc v Coats Paton Plc* [1989] B.C.L.C. 233.
189 It is regarded as a breach of fiduciary duty for a director to vote against proceedings in order to save his own skin where the proposed litigation is in the company's interests: *Fusion Interactive Communication Solutions Ltd v Venture Investment Placement Ltd (No 2)* [2005] EWHC 736 (Ch), [2005] 2 B.C.L.C.571 para.49.
190 *Davidson v Beggs Antiques Ltd v Davidson* [1997] B.C.C. 77.
191 *Taylor v National Union of Mineworkers (Derbyshire Area)* [1985] B.C.L.C. 237 at 254-255.

6.1.2 The shareholders as plaintiffs

6.1.2.1 In their own name

Shareholders will not be able to sue in their own name unless there is a breach of a personal duty owed to them. Any breach of a duty owed by the directors to the company will be treated as reflective loss which precludes a suit in the name of anyone other than the company itself.[192]

In some circumstances, a shareholder who is burdened by the wrongdoing of directors may be able to claim statutory oppression under the terms of s.205 of the Companies Act 1963. Under s.205, where a member makes a case that the affairs of the company are being conducted or that the powers of the directors are being exercised in a manner which is oppressive to him or any other member, he may apply to court for a remedy.[193] Opting to present a s.205 petition has much to recommend it, given the difficulties of mounting a derivative action. A favourable result of such an action will damage the management of the company that has been run oppressively; it will not, however, directly benefit the initiator of the action. The fact that a derivative action is possible in any given instance does not disentitle a member from bringing a s.205 petition. Although there is a broad discretion given to the courts as to the provision of a remedy for oppression, the Supreme Court has held that damages are not available as a remedy.[194] This differentiates Ireland from the United Kingdom and other common law countries where damages are available as a remedy for oppression / unfair prejudice.

6.1.2.2 In the name of the company ('derivative action')

In exceptional circumstances, where a company chooses not to sue a director for breach of duty, a derivative claim may be brought by a member of the company in a representative capacity to enforce the company's rights in respect of a breach of directors' duties.[195] This may only occur, however, in very limited circumstances.[196]

The practical significance of the obstacles to mounting a derivative action are considerable. It is not easy to establish *locus standi* as the interest involved is regarded by the court as equitable.[197] In addition, the claim must be brought on the company's behalf which means that the shareholder taking the action will not directly benefit personally.

It has been the case that Irish courts have not seen fit to depart from a conservative approach with regard to derivative actions and the Irish Parliament (the Oireachtas) has chosen not to legislate in this area. Given the very great difficulty from both a practical and theoretical perspective in bringing a derivative action, it is likely that it would only be undertaken in cases where the party could not bring an oppression petition under s.205 of the Companies Act 1963. Academic commentary on the matter

192 *O'Neill v Ryan* [1993] ILRM 557; D. Ahern, "The Rule Against Shareholders' Recovery of Reflective Loss" (2005) 112 Commercial Law Practitioner 163.
193 See J. Temple-Lang, "Minority Shareholder Protection under Irish Law2 (1974) N.I.L.Q. 387; P. Ussher, "Company Law-Oppression, Justice, Equity" (1979-1980) D.U.L.J.92; L McCann, "Minority Shareholder Protection: Sections 205 and 213(f) of the Companies Act 1963 (1995) DlÍ –The Western Law Gazette 85.
194 *Irish Press Plc v Ingersoll Irish Publications Ltd* unreported, High Court, Barron J., 15 December 1993.
195 A derivative action is here understood as a species of representative action brought on behalf of all shareholders (other than those of the defendants): Cooke v Cooke [1997] 2 B.C.L.C. 28.
196 The policy behind the derivative action is detailed in the celebrated case *Wallersteiner v Moir (No 2)* [1975] Q.B. 373.
197 *Hooker Investments Pty Ltd v Email Ltd* (1986) 10 A.C.L.R. 443; *Fulloon v Radley* [1992] 2 Qd.R.290; *Svanstrom v Jonasson* (1997) C.I.L.R. 192.

to the effect that ‘‘the derivative action as a minority shareholder governance mechanism seems to be almost a dead letter” seems apt.[198]

The failure to review the derivative action in recent company law policy debates reflects the modern policy shift in Ireland to a public enforcement model within the context of a view of company law in purely black letter terms. This perspective concentrates on compliance as serving a public interest function, rather than the interests of the investing shareholders. Indeed, while there are considerable difficulties in seeking to bring breaches of directors duties within the exceptions to the rule in *Foss v Harbottle*[199] in this jurisdiction, the UK’s Companies Act 2006 has reformed the derivative action and s.260(3) of the 2006 Act makes clear that a derivative action may be brought “ in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company.” By contrast, the Irish courts must still wrestle with complex rules to determine whether or not a derivative action for a breach of directors’ duties is permissible.[200]

Although there are no rules of court regulating the procedure to be adopted by a minority shareholder who wishes to maintain a derivative action on behalf of a company, it is now best practice to apply to the court for leave to do so. A shareholder who is unhappy with the decision of the board or the general meeting not to institute proceedings in respect of an alleged breach of directors’ duties must establish their locus standi based on an exception to the rule in *Foss v Harbottle* to engage in litigation on behalf of the company in a leave application.

A shareholder is allowed to bring a derivative action on behalf of a company where the action is brought bona fide for the benefit of the company for wrongs to the company and not for an ulterior purpose. If it is sought to bring an action for an ulterior purpose, the court may not allow the derivative action to proceed.[201] In *Fanning v Murtagh*[202] Irvine J. noted that the intending plaintiff did not have support for the derivative claim from even one other shareholder of the company’s 1,400 shareholders. Thus support from other shareholders is a factor considered in leave applications for the maintenance of derivative proceedings.

The authorities indicate that if the court decides to sanction a minority shareholder to maintain a derivative action, there is a high likelihood that the plaintiff will obtain an indemnity in respect of costs from the company.[203]

Under the fraud on the minority exception, a derivative action will be allowed in just a few cases. There is a requirement that the persons against whom the action is taken must have majority control of the company and have blocked an action being brought in the name of the company.[204] The minority in question refers to the minority of the members being one or more who wish to sue in the face of majority opposition of the general meeting (and/or that of the board). *Prudential Assurance Co*

198 I. Lynch Fannon, “A Transatlantic Case: the Derivative Action as a Corporate Governance Tool” (2005) 12 *Dublin University Law Journal* 1 at 27; D. Ahern, “Directors’ Duties: Broadening the Focus Beyond Content to Examine the Accountability Spectrum” (2011) 33 *Dublin University Law Journal* 116..
199 (1843) 2 Hare 461.
200 This argument is presented in D Ahern *Directors’ Duties: Law and Practice* (2009)at chapter 8.
201 *Fanning v Murtagh* [2008] IEHC 277, [2009] 1 I.L.R.M. 368.
202 [2008] IEHC 277, [2009] 1 I.L.R.M. 368.
203 *Glynn v Owen* [2007] IEHC 328; unreported, Finlay Geoghegan J., October 5, 2007; *Fanning v Murtagh* [2008] IEHC 277, [2009] 1 I.L.R.M. 368.
204 *Burland v Earle* [1902] A.C. 83.

Ltd v Newman Industries Ltd (No2)[205] established that in order to qualify for a derivative action based on a fraud on a minority, the plaintiff must show both wrongdoing by those in control and he must have a good prima facie case.[206] Furthermore, the Irish courts do not favour negligence falling within this exception. A justice based exception may also have some limited application. In Ireland, this has its roots in *Moylan v Irish Whiting Manufacturers Ltd*[207] where Hamilton J. expressed the view that having regard to the provisions of the Irish Constitution, "an exception to the rule must be made when the justice of the case demands it."[208] However, it would appear that this would only apply in exceptional circumstances.

6.2 Criminal law and administrative sanctions

Criminal law is usually not invoked in cases of suspected breaches by directors of their common law and equitable duties. Academic opinion in Ireland is mostly inclined to the view that attaching criminal sanction would risk sliding towards an environment of over-deterrence.[209] There is the complication that given the fact that a director is regarded in law as a constructive trustee any questionable gains by him within the company cannot automatically be regarded as theft.[210] The restriction and disqualification regimes in Part 7 of the Companies Act 1990 are regarded as sufficiently stringent. They face both ways: they are both a means of deterrence and sanction. It remains the case that where a director has not complied with his statutory duties, a criminal offence may also have been committed.[211]

205 [1982] Ch. 204
206 This was endorsed by the Irish High Court in *Fanning v Murtagh* [2008] IEHC 277, [2012] 1 I.L.R.M. 368.
207 (1980) [1963-1999] Ir.Co. Law Rep.280.
208 (1980)[1963-1999]Ir.Co.Law Rep.280 at 287.
209 See D Ahern Directors' Duties: Law and Practice at chapter 8 and E Ferran, " Corporate Law, Codes and Social norms – Finding the Right Regulatory Combination and Institutional Structure" (2001) 1 J.C.L.S. 381 at 408.
210 *Attorney General's Reference (No1 of 1985*) [1986]Q.B.491.
211 E.g.s.202 of the Companies Act 1990 (failure to maintain proper books of account), s.60 of the Companies Act 1990 (failure to provide a copy of the register of directors' interests), s.127(12) of the Companies Act 1963 (as amended by the Company Law Enforcement Act 2001, s.60) (failure to file annual returns on time).

7 Conflict of Laws

7.1 Classification under Ireland's private international law

In Ireland matters relating to insolvency law are dealt with in the Companies Acts 1963 -2012. There is not a practice of creating a separation of insolvency law from company law.

7.1.1 Company law

The common law and equitable duties of directors in terms of duties of care and loyalty are regarded as within company law.

7.1.2 Tort law

Negligence, misrepresentation and deceit are classified as falling within the law of tort.

7.1.3 Special duties in the vicinity of insolvency

Breaches of the non-statutory duties of directors would be regarded as breaches of company law. There is no express designation of other breaches such as in relation to reckless trading as breaches of insolvency law rather than company law.

As noted earlier, company law in Ireland very much reflects that of the UK. The creditor protection system operating here relies on indirect remedies and has all the weaknesses of the UK system outlined by Schall.[212] In the Irish system, a creditors' voluntary liquidation is governed by ss.265-273 of the Companies Act 1963. With regard to directors' duties, the following is applicable. The legislation in Ireland is somewhat weaker than that found under s.214 of the UK Insolvency Act 1986. In the Irish case, there is a possible liability for reckless trading, in certain instances. Directors' liability for reckless trading where applicable is governed by s.138 of the 1990 Companies Act, inserting a new section 297A into the Companies Act 1963. Section 297A(1) provides that if in the course of winding-up of a company or during an examinership a case for reckless trading can be made out, on the application of a receiver, examiner, liquidator or any creditor or contributory to the company, a court may judge a director to be personally liable without limit for the company's debts. Reckless trading is not defined in s.297A(1) of the 1963 Companies Act. There are, however, two alternative tests to determine matters as set out in s. 297A(2) (a) and (b) – the objective and subjective tests. The objective test allows for consideration of the general knowledge, skill and experience of the director and what can reasonably be expected of the person being investigated. The subjective test of recklessness applies where the director "was party to the contracting of a debt but did not honestly believe, on reasonable grounds, that the company would be able to pay the debt when it fell due for payment (including all contingent and prospective liabilities)."

212 J Schall, "The UK Limited Company Abroad" [2005] EBLR 1540.

7.2 Application of the relevant private international law rule

Ireland follows the incorporation theory whereby companies are governed by the law of the place of incorporation.[213] The concept of the seat has no place under domestic law. For the Companies Acts 1963-2012 have no application to companies formed in another jurisdiction although there is a recognition of branches of overseas companies operating in Ireland based on the 11th Company Directive (89/666/EC). Thus, as in the UK, the *lex incorporationis* applies in relation to directors' duties.[214] Pursuant to the incorporation theory which is recognised in Ireland, where a company is formed under the law of a state it remains governed by the law of the state of incorporation, even if it transfers its centre of operations to another country. This principle applies in relation to the equitable duties of directors which are regarded as being concerned with the internal management of the company. This can be seen in a number of decisions of the English courts.[215] However, there is also persuasive authority from the English Court of Appeal to the effect that the duty of care in tort (but not the equitable duty of care) will be governed based on the proper law of the tort based on the place where the substance of the tort arose.[216]

In insolvency, the expectation will be that a proposed liquidation will apply to all the assets and affairs of a company. This would suggest that an Irish liquidator should be competent to take possession of and realise all the assets of a company irrespective of where they are situated. In practice, this depends on whether the relevant authorities or third parties in other jurisdictions are willing to recognise the fact that the company is in liquidation and the status and powers of the liquidator. It cannot be assumed that merely because the liquidator has been properly appointed under Irish company law his appointment will be recognised worldwide.

Even if, as a practical matter, third parties can be persuaded to recognise the status of the liquidator, it will frequently be the case that governmental authorities or statutory authorities charged with maintaining public registers of interests in assets, such as immovable property or intellectual property, may not be empowered to recognise an appointment unless in their own jurisdiction a court order has been made recognising the appointment and giving it local effect.

The extent of recognition varies in different jurisdictions. There are, however two procedures found in many jurisdictions where local courts are asked to assist, which are orders in aid and local winding-up proceedings. Many jurisdictions approach the issue of recognition of foreign insolvency proceedings from the point of view of reciprocity and orders in aid are sometimes granted in cases where the courts of the foreign state concerned also make such orders under a corresponding provision.

Section 250 of the Companies Act 1963 provides that an order made by a court of any country recognised for the purposes of that section and made for or in the course of winding-up a company may be enforced by the Irish High Court in the same manner in all respects as if the order had been made by the Irish High Court itself. Thus the court will recognise such a foreign order. The only country in respect of which the necessary ministerial order has been made for the purposes of this section is Great Britain and Northern Ireland. Section 250 has recently been amended, so that it does not apply in relation to an order made by a court of a state to which the EU Insolvency Regulation applies.

[213] *Kutchera v Buckingham International Holdings Ltd* [1988] I.L.R.M. 501.
[214] See *Konamaneni v Rolls-Royce Industrial Power (India) Ltd* [2002] 1 W.L.R. 1269.
[215] *Pergamon Press Ltd v Maxwell* [1970] 1 W.L.R. 1167, 1172; *Konamaneni v Rolls Royce Industrial Power (India) Ltd* [2002] 1 W.L.R. 1269, [55]; *Base Metal Trading Ltd v Shamurin* [2004] EWCA Civ 1316, [2005] 1 W.L.R. 1157.
[216] *Base Metal Trading Ltd v Shamurin* [2004] EWCA Civ 1316, [2005] 1 W.L.R. 1157.

As far as restructurings are concerned, s.36 of the Companies (Amendment) Act 1990 provides similarly that any order made by a court of any country recognised for the purposes of that section and made for or in the course of reorganisation or reconstruction of a company may be enforced by the Irish High Court. No recognition order has yet been made under this section.

Historically, there has been little harmonisation in insolvency law throughout Europe or elsewhere. This is largely explained by the fact that although insolvency in many jurisdictions is largely a matter of company law, it is characterised also by principles based on other disciplines such as the laws of property and equity and certain regulatory controls. It has proven difficult to harmonise substantive laws, because these laws are not uniform.

Council Regulation (EU) no.1346/2000 on insolvency proceedings is not an attempt to harmonise substantive laws. It does, however, establish a regime for the improved efficiency and effectiveness of cross-border insolvencies. This is achieved by providing for cross-border recognition and enforcement of basic orders such as the appointment of liquidators and other insolvency office holders. It also allows for the recognition of remedies typically invoked in insolvency proceedings. It establishes a regime for the management of asset realisation and the processing of creditor claims in multi-jurisdictional cases.

While harmonisation is not the objective, the Regulation contains some substantive provisions which achieve a form of limited harmonisation for individual cases by the mandatory application of the laws of the Member State in which insolvency proceedings are opened.

The Regulation is expressed to apply to:

> "Collective insolvency proceedings, which entail the partial or total divestment of a debtor and the appointment of a liquidator."[217]

The Annex to the Regulation stipulates for each jurisdiction the category of proceedings which this includes. In the case of Ireland, these are listed as including compulsory winding- up, bankruptcy, administration in bankruptcy of the estate of persons dying insolvent, winding-up in bankruptcy of partnerships, creditors' voluntary winding-up (with confirmation of a court), arrangements under the control of the court which involve the vesting of all or part of the property of the debtor in the official assignee for realisation and distribution and company examinerships. While the Regulation provides for creditors voluntary winding-up (with confirmation of a court), the concept of voluntary liquidation in Ireland generally means, by definition, that there has been no court order. The Corporate Insolvency Regulations[218] applicable in Ireland establish a procedure whereby such a liquidator can apply to have his appointment confirmed by a certificate of a Master of the High Court, thereby bringing it within the scope of the Regulation.

Regulation (EC) No.864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations defines the conflict-of-law rules applicable to non-contractual obligations in civil and commercial matters, including product liability, negotiorum gestio (acts relating to the affairs of another person) and *culpa in contrahendo* (non-contractual obligations arising out of dealings before the conclusion of a contract). It does not attempt to harmonise the

217 Article 1
218 S I 333/2002.

substantive law of the signatories in the field of non-contractual obligations, but only their conflict-of-law rules, so that, no matter where in the EU an action is brought, the rules determining the applicable law will always be the same. It came into force in Ireland as elsewhere in the EU, excepting Denmark, on the 11 January 2012.

Rome 2 applies to non-contractual obligations only. It does not apply to revenue, customs or administrative matters or to the liability of the State. Additionally the Regulation does not cover non-contractual disputes relating to family matters, matrimonial property, bills of exchange, cheques or trust law. The general rule is that the law of the country in which the damage occurs is the applicable law, unless the person claimed to be liable and the person sustaining the damage have their habitual residence in the same country. This rule does not apply if the tort or non-contractual obligation is manifestly more closely connected with another country. The definition of "more closely connected" is yet to be interpreted by the European Court of Justice. Notwithstanding the general rule, there are special rules governing product liability (Article 5), unfair competition and acts restricting free competition (Article 6), environmental damage (Article 7), infringement of intellectual property rights (Article 8) and industrial action (Article 9).

The Regulation also lays down rules for the jurisdiction in which proceedings can be pursued for non-contractual damages. The Regulation makes provision for parties engaged in commercial activity to agree in advance the law of the jurisdiction to which they will submit any disputes, should disputes arise.

In relation to jurisdiction, this is governed by the EC Regulation on Civil Jurisdiction and Judgments.[219] Under this Regulation jurisdiction will be determined by ascertaining where the company has its seat in accordance with the Member State's rules. Ireland will equate the seat with a company's place of incorporation.

[219] Council Regulation (EC) No. 44/2001 of 22 December 2000.

Directors' Duties and Liability in Italy

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CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in Italy

The provisions contained in the Civil Code[1] are the fundamental source of regulation for companies (*societa' di capitali*) incorporated in Italy. They are not, however, the only source. Italian listed companies and issuers of financial instruments that, although not listed on a regulated market, are widely distributed among the public[2] (*societa' che fanno ricorso al capitale di rischio*[3]), have to comply with the provisions contained in the Consolidated Financial Services Act no 58 of 1998, as amended (the 'CFSA'), and with the relevant secondary legislation[4] enacted by Consob.[5]

Moreover, in the case of listed companies, the legal framework is further integrated and supplemented by the listing rules of the markets organised and managed by Borsa Italiana S.p.A. (*Regolamento dei Mercati*)[6] and the principles of the Corporate Governance Code (*Codice di Autodisciplina*).[7]

Italy is a civil law jurisdiction and the *stare decisis* doctrine plays no role in the evolution of law.[8] However, the decisions of the *Corte di Cassazione* (Supreme Court), even if not binding, offer uniformity in the interpretation of the law and the *massime* (headnotes) provide comfort to lawyers in the presence of an uncertain legislative text. Academic writing is often influential in the interpretation of company law, but it is not a source of law.

[1] Libro V, Titolo V, Capo V-XI Civil Code.
[2] Art. 2325-*bis* Civil Code.
[3] Broadly consistent with the notion of public company set out under CA 2006, s. 4(2) and Part 20.
[4] Namely Consob Regulation no. 11971 of 14 May 1999 (provisions on issuers), as amended; Consob Regulation no. 16190 of 29 October 2007 (provisions on intermediaries), as amended; and Consob Regulation no. 16191 of 29 October 2007 (provisions on markets), as amended.
[5] Consob is the public authority responsible for regulating the Italian securities market (www.consob.it).
[6] Borsa Italiana S.p.A. is the company responsible for the organisation and management of the Italian stock exchange. Borsa Italiana (www.borsaitaliana.it) is part of the London Stock Exchange Group (www. http://www.londonstockexchangegroup.com/home/homepage.htm).
[7] The Italian Corporate Governance Code (*Codice di Autodisciplina* - available at http://www.borsaitaliana.it/borsaitaliana/regolamenti/corporategovernance/corporategovernance.en.htm), is a voluntary code (both adoption and compliance). That said, art 123 *bis* CFSA requires the directors' report of issuers with securities admitted to trading on regulated markets to contain a specific section entitled: «Report on corporate governance and ownership structures» and Main Principle no 3 of the same Corporate Governance Code provides that if the issuer has not implemented, in whole or in part, one or more recommendations contained in the Code, it has to supply adequate information with regard to the reasons for the omitted or partial application. Compliance with information disclosed to the public is monitored by the board of statutory auditors who, according to art. 149(1)(c)*bis* CFSA, verifies "the arrangements for implementing the corporate governance rules provided for in codes of conduct drawn up by regulated stock exchange companies or by trade associations". There are not, however, legal consequences for non-compliance except for shares listed on the STAR market segment of Borsa Italiana (i.e. a segment of Borsa Italiana's equity market (MTA) dedicated to midsize companies with capitalization of less than one billion euros) pursuant to art 2.2.3 of the listing Rules of the Markets organised and managed by Borsa Italiana S.p.A. where compliance with some of the rules of the Corporate Governance Code is mandatory. See G Ferrarini and P Giudici 'La Legge sul risparmio, ovvero un pot-pourri della corporate governance' (2006) Rivista delle Societa' 573.
[8] See Art. 1 Regius decree no 262 of 16 march 1942 (*disposizioni sulla legge in generale*) where the sources of Italian law are defined.

1.2 Corporate landscape in Italy

The Italian capital market has always been underdeveloped in size when compared to other major European economies. The most significant source of financing for medium-sized companies (at the heart of the Italian economic model) is still offered by the banking system (*struttura banco-centrica*). Between 2000 and 2010, the number of Italian listed companies shrunk from 297 to 286, and so did the aggregate market capitalisation (from 818 to 423 billion Euros).[9]

According to the Civil Code, Italian companies are divided into three main categories: public companies (*societa' per azioni*),[10] private companies (*societa' a responsabilita' limitata*)[11] and limited partnerships by shares (*societa' in accomandita per azioni*).[12] They exist as legal persons separate from their members following incorporation. This is achieved by registration with the Companies Registrar (*Registro delle Imprese*)[13] kept by the Chamber of Commerce (*Camera di Commercio*) in every Italian province.[14]

Incorporation under the Civil Code does not *per se* bring the benefits of limited liability: while in the case of registered public and private companies, members are not liable for the company's debts (if not within the limits of their contributions or the residual amount, if any, of partly paid shares/quotas),[15] in the case of registered limited partnerships by shares (*societa' in accomandita per azioni*) only the limited partners (*accomandanti*) are liable up to what they have agreed to contribute on entering into the partnership.[16]

Limited liability is also available to single-member public and private companies,[17] if the rules on minimum capital requirement[18] and disclosure in the Companies Register (*Registro delle Imprese*) are duly complied with.[19]

As opposed to the company laws of other jurisdictions such as the UK, the Civil Code provides a different set of regulations for public and private companies. This is on the basis that only corporate capital for public companies is divided into shares and that private companies cannot offer to the public any of their securities,[20] nor create pools of dedicated assets to a specific business activity

[9] See Consob 'Relazione per l'anno 2010' (March 2010), available at http://www.consob.it/main/consob/pubblicazioni/relazione_annuale/relazione.html?symblink=/main/consob/pubblicazioni/relazione_annuale/index.html (accessed 29 March 2012).
[10] Arts. 2325 – 2451 Civil Code.
[11] Arts. 2462 – 2483 Civil Code.
[12] Arts. 2452 – 2461 Civil Code.
[13] Art. 2331 (1) Civil Code (public companies); art. 2463 (3) Civil Code (private companies) and art. 2454 Civil Code (limited partnerships by shares).
[14] Pursuant to law no 580 of 1993. See C Ibba 'Registro delle Imprese' (2008) Rivista del Notariato 513.
[15] Art. 2325 (1) Civil Code (public companies) and art. 2462 (1) Civil Code (private companies)."
[16] General partners (*accomandatari*) who are directors by operation of law (Art. 2454 Civil Code) are liable for company's obligations to the full extent of their property (Art. 2452 Civil Code).
[17] Art. 2463 (1) Civil Code (private companies) and 2328 (1) Civil Code (public companies), respectively.
[18] I.e. the rules according to which the entire nominal (if any) value of the shares/quotas must be paid at the time of issue or when only one member remains (Art. 2342 (2) Civil Code and Art. 2464 (4) Civil Code, respectively), at the risk of losing limited liability (Art. 2325 (2) Civil Code and 2462 (2) Civil Code).
[19] Art. 2362 Civil Code and Art. 2470 Civil Code. The possible consequences are the loss of limited liability (Art. 2325 (2) Civil Code and 2462 (2) Civil Code) and the limited enforceability of the contracts entered with the company (Art. 2362 (5) Civil Code and 2478 (3) Civil Code).
[20] Art. 2468 Civil Code. A further difference is that while the minimum capital requirement for public companies is Euros 120,000.00 (Art. 2327 Civil Code), the minimum for private companies is Euros 10,000.00 (2463 Civil Code).

(*patrimoni destinati ad uno specifico affare*)[21] or financial agreements of a specified business activity, where all or part of the cash flows generated from such activity will be allocated in priority to the repayment of all or any part of such financing (*finanziamenti destinati ad uno specifico affare*).[22]

The ownership structure of Italian public companies has historically been regarded as concentrated. Controlling power has usually been held by a dominant shareholder (often) by means of a pyramidal structure of controlled subsidiaries or shareholder ties (*patti di sindacato*), frequently supported by the strong links with the banking system.[23] This scenario has not changed in the past years and, inevitably, it still distinguishes the Italian pattern of corporate ownership and control, influencing the evolution/reform of corporate governance.[24]

1.3 The board of an Italian company

The 2003 company law reform[25] has introduced three alternative models of corporate governance (*sistemi di amministrazione e controllo*) for Italian public companies. These are all based on a core set of mandatory rules.

The default model[26] is the 'traditional' one (*sistema tradizionale*), which provides that the board of directors (*consiglio di amministrazione*), the board of statutory auditors (*collegio sindacale*) and external auditors (*revisori contabili*) are all appointed by ordinary shareholders' resolution.[27] Under the traditional model, directors have sole responsibility for managing the company,[28] statutory auditors for monitoring directors' compliance with the principles set out in the law and in the articles,[29] and external auditors for revising the company's accounts.[30] As opposed to appointment rights, shareholders' removal rights operate unevenly: while directors can be removed at any time by ordinary resolution without cause,[31] auditors (both statutory and external) can only be removed with cause and following court approval.[32]

The 'two-tier model' (*sistema dualistico*) applies only if expressly stated in the articles.[33] It comprises a supervisory board (*consiglio di sorveglianza*) appointed by ordinary shareholders' resolution[34] and a management board (*consiglio di gestione*). The supervisory board is formed by at least three

[21] Arts. 2447-*bis* – 2447 *novies* Civil Code. See D Scarpa 'Inizio e fine del patrimonio del patrimonio destinato tra adeguatezza e responsabilita'' (2009) Giurisprudenza Commerciale 1041.
[22] Art. 2447 *decies* Civil Code.
[23] See M Bianchi e M Bianco ' Italian corporate governance in the last 15 years : from pyramids to coalitions ?' (2006) ECGI – Finance working paper no 144, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952147 (accessed 25 February 2012).
[24] See L Enriques and P Volpin 'Corporate governance reforms in continental Europe' (2007) Journal of Economic Perspectives 117.
[25] Legislative Decree no. 6 of 2003.
[26] I.e. it applies when the articles do not provide otherwise - Art. 2380 (1) Civil Code.
[27] With the exception of the directors and statutory auditors appointed on initial registration. Arts. 2383 (1), 2400 (1) and 2409 *quarter* Civil Code, respectively.
[28] Art. 2380 *bis* Civil Code.
[29] Art. 2403 (1) Civil Code.
[30] Art. 2409 *bis* Civil Code.
[31] Art. 2383 (3) Civil Code.
[32] Arts. 2400 (2) and 2409 (3) *quarter* Civil Code, respectively.
[33] Arts. 2380 (1) and 2409 *octies* Civil Code. Unless otherwise provided in the special resolution that amends the articles, the change from the traditional model takes effect as of the date of the shareholders' meeting convened for the approval of the annual accounts for the following financial year – Art. 2380 (2) Civil Code.
[34] With the exception of the members of the supervisory board appointed on initial registration of the company. See Art. 2409 (2) *duodecies* Civil Code.

members[35] and one of them must be an external auditor.[36] The auditor is not entitled to interfere in the management of the company, but carries out certain functions that, in the traditional model, belong to the general meeting[37] and statutory auditors.[38] On the other hand, the management board has sole responsibility for the management of the company[39] and is composed of at least two members[40] who are appointed by the supervisory board[41] and who cannot be members of the supervisory board.[42] Finally, even the two-tier model requires the presence of external auditors who are appointed by shareholders' resolution and are in charge of revising the company's accounts.[43] Under the two-tier model, members of the management board can be removed by the supervisory board at any time without cause[44] and external auditors can be removed with cause and following the court's approval.[45] The case of the members of the supervisory board is slightly different as they can be removed at any time by ordinary shareholders' resolution without cause and without court approval.[46]

The third available model of corporate governance under the Civil Code is the 'one-tier model' (*sistema monistico*), which, like the two-tier model, applies only if expressly adopted in the articles.[47] Under the one-tier model, the board of directors (*consiglio di amministrazione*) is appointed by shareholders' resolution[48] and it has sole responsibility for the management of the company.[49] At least one third of the directors must be non-executive and independent in accordance with the requisites provided for statutory auditors by the Civil Code[50] or, if so indicated in the articles, in accordance with the provisions contained in the corporate governance codes drawn up by regulated stock exchanges or by trade associations.[51] Some of the independent non-executive directors[52] form an internal committee appointed by the board and named 'management control committee' (*comitato per il controllo sulla gestione*), which, even if in weaker terms than for the statutory auditors under the traditional model,[53] is in charge of supervising and monitoring the management of the business.[54] As in the traditional and in the two-tier models, an external auditor must be appointed who has the task of reviewing the company's accounts.[55] While both executive and non-executive directors may be removed at any time and without cause by ordinary shareholders' resolution,[56] the external auditor can only be removed with cause and following approval by the court.[57]

[35] Which do not necessarily have to be shareholders - Art. 2409 (1) *duodecies* Civil Code.
[36] Art. 2409 (4) *duodecies* Civil Code.
[37] Eg. directors' appointment and removal - 2409 *terdecies* (1) (a) Civil Code.
[38] E.g. the supervision of directors' compliance with the principles set out in the law/articles – management of the business pursuant to Art. 2403 (1) Civil Code. Art. 2409 *terdecies* (1) (c) Civil Code.
[39] Art. 2409 (1) *novies* Civil Code.
[40] Art. 2409 (2) *novies* Civil Code.
[41] Art. 2409 (3) *novies* Civil Code.
[42] Art. 2409 (4) *novies* Civil Code.
[43] Art. 2409 *quinquiesdecies* Civil Code.
[44] Art. 2409 (5) *novies* Civil Code.
[45] Art. 2409 *quinquiesdecies* Civil Code by reference to Art. 2409 (3) *quarter* Civil Code.
[46] Art. 2409 (5) *duodecies* Civil Code. This is primarily in order to overcome potential detrimental consequences in a takeover situation where the successful bidder could find otherwise impossible to remove the incumbent supervisory board while it is in office.
[47] Arts. 2380 (1) and 2409 *sexiesdecies* Civil Code.
[48] With the exception of the directors appointed on initial registration of the company. See Art. 2383 Civil Code by reference made in Art. 2409 *noviesdecies* Civil Code.
[49] Art. 2409 (1) *septiedecies* Civil Code.
[50] Art. 2339 Civil Code.
[51] Art. 2409 (2) *septiedecies* Civil Code.
[52] The number varies depending on whether the company is an issuer of financial instruments that, although not listed on a regulated market, are widely distributed among the public (*societa' che fanno ricorso al mercato del capitale di rischio*) - Art. 2409 (1) *octiesdecies* Civil Code.
[53] E.g. the inspection powers under Art. 2403 *bis* Civil Code do not apply to the management control committee.
[54] Art. 2409 *octiesdecies* Civil Code.
[55] Art. 2409 (2) *noviesdecies* Civil Code.
[56] Art. 2409 (1) *noviesdecies* Civil Code by reference to Art. 2383 Civil Code.
[57] Art. 2409 (2) *noviesdecies* Civil Code by reference to Art. 2409 *quater* Civil Code.

1.3.1 Distribution of decision-making power under Italian company law

The powers of the directors of Italian public companies are set out in the Civil Code. Outside the specific circumstances where shareholders expressly retain decision-making authority,[58] the board has the sole responsibility for the management of the company (*la gestione dell'impresa spetta esclusivamente agli amministratori*).[59]

As opposed to the scenario preceding the 2003 company law reform,[60] this distribution of powers cannot be altered by the articles or following a shareholders' resolution.[61] Section 2364(1) no 5 Civil Code, in particular, expressly states that, although shareholders may be entitled by the articles to authorise a director's decision, this authorisation is not binding on the director and does not limit their liability for the actions taken.[62] That said, a number of commentators maintain that shareholders' authorisation may still be relevant, as it indirectly imposes the duty (of loyalty) to explain and justify their decisions on directors who comply with the shareholders' resolution.[63]

The scenario is different for private companies where the articles of association can expand the shareholders' decision-making powers and, additionally, directors or shareholders representing 1/3 of the outstanding corporate capital can ask shareholders' approval on a case-by-case basis.[64] In these latter cases, shareholders who authorise the decision become jointly and severally liable with the directors.[65]

A genuine co-determination power does not exist in Italy. However, employees may influence the selection of the directors. A special shareholders' resolution may in fact authorise the issuance of certain financial instruments other than shares (*strumenti finanziari*) to the company's employees, which carry peculiar economic and administrative rights.[66] Included among those rights is usually the right to appoint an independent member of the board of directors or of the supervisory board in accordance with the terms contained in the articles.[67]

[58] Art. 2364 (1) no 5 Civil Code (eg. dividends' distribution according to Art. 2433 (1) Civil Code).
[59] Art. 2480 (1) *bis* Civil Code (traditional model), Art. 2409 (1) *novies* Civil Code (two-tier model) and 2409 (1) *septiesdecies* Civil Code (one-tier model).
[60] See Art. 2364 (1) n. 4 Civil Code (pre 2003).
[61] See C Angelici 'Introduzione alla riforma delle societa' di capitali' in P Abbadessa and GB Portale (eds) *Il nuovo diritto delle societa*' – Liber Amicorum Gian Franco Campobasso (Utet Torino 2006), vol I 3.
[62] Art. 2364 (1) no. 5 Civil Code.
[63] See V Pinto 'Brevi osservazioni in tema di deliberazioni assembleari e gestione dell'impresa nella societa' per azioni' (2004) Rivista del diritto dell'Impresa 446; A Tina L'esonero da responsabilita' degli amministratori di s.p.a. (Giuffre' Milano 2008) 252 and I Maffezzoni 'sub art 2364' in P Marchetti, LA Bianchi, F Ghezzi and M Notari Commentario alla riforma delle societa' (Egea Milano 2008) 24.
[64] Art. 2479 (1) Civil Code.
[65] Art. 2476 (7) Civil Code. This has to be read together with Art. 2468 (3) Civil Code where members may have a managerial role, if so provided by the articles.
[66] Art. 2349 (2) Civil Code.
[67] Art. 2351 (5) Civil Code.

2 THE CONCEPT OF 'COMPANY DIRECTOR' IN ITALY

2.1 *De iure* directors

2.1.1 Requirements to become a *de iure* director

Under the traditional and one-tier models of corporate governance, directors are appointed by ordinary shareholders' resolution[68] and in the two-tier model by the supervisory board.[69] There are three exceptions to these general rules. Firstly, the holders of financial instruments without voting rights issued by the company pursuant to articles 2346 (6) and 2349 (2) Civil Code have the right to appoint an independent member of the board of directors (or of the supervisory board in the two-tier model).[70] Secondly, in partially state-owned companies, the State may be entitled to appoint a number of directors or members of the supervisory board, either in compliance with the articles of association or by law (*leggi speciali*).[71] Finally, in privatised companies, the Treasury has a special power to appoint an independent director who can attend board meetings, but does not have voting rights.[72]

That said, in general, it is still possible to state in the articles that some of the directors have to be appointed by minority shareholders. This can be achieved by using the device of the election by list of candidates (*voto di lista*). Such device is now mandatory for listed companies where at least one member of the board of directors has to be elected from the minority slate that obtained the largest number of votes and is not linked in any way, even indirectly, to the shareholders who presented or voted for the list that obtained most votes.[73] Furthermore, in public listed companies a specific affirmative action aims at achieving gender equilibrium within the board: the underrepresented gender must have at least 1/3 of board seats.[74]

There are no limitations on the number of directors that can be involved in the management of the company,[75] but boards consisting of a single director are only permissible if the company adopts the "traditional model". Under the two-tier and one-tier models the presence of a board of directors is a necessary requirement.

While in the traditional and in the one-tier model the maximum number of directors that can be appointed is set out in the articles,[76] in the two-tier model, the number of members of the management board (*consiglio di gestione*) is established by the supervisory board (*consiglio di sorveglianza*) in compliance with the articles.[77]

[68] Art. 2383 (1) Civil Code in the traditional model and Art. 2409 (1) *noviesdecies* by reference to in the one-tier model.
[69] Art. 2409 (3) *novies* Civil Code.
[70] Art. 2351 (5) Civil Code.
[71] Art. 2449 (1) Civil Code.
[72] Art 2 (1) (d) Law Decree no. 332 (1994).
[73] Art 147 (3) *ter* CFSA. A similar pattern applies to privatized companies pursuant to art 4 Law Decree no.332 (1994).
[74] Art. 147 (1-ter) *ter* CFSA.
[75] Art. 2380 *bis* Civil Code.
[76] Art. 2380 (4) *bis* Civil Code.
[77] Art. 2409 (3) *novies* Civil Code.

The Civil Code specifies a mandatory term of office for directors of public companies: they cannot be appointed for more than three years and all directors must retire at the third annual general meeting. At the end of their term the same directors may be reappointed by ordinary resolution, if so provided in the articles.[78]

Subject to the articles and the shareholders' ordinary resolution, the directors may delegate some of the powers[79] that are conferred on them by the articles to a managing director or a managerial committee (*amministratore delegato* and *comitato esecutivo*).[80]

Particulars of the directors must be filed with the Companies Register within thirty days from the appointment indicating whether they can act as agents (*rappresentanti*) on behalf of the company.[81]

Directors in public companies may be removed by ordinary resolution (or by a decision taken by the supervisory board in the two-tier model) at any time and without cause. In the latter case, the director is entitled to compensation for breach of his/her employment contract by the company.[82]

The only exception to the general rule is the case of companies where one or more directors have been appointed by the state.[83] The removal right in this case does not belong to the shareholders, but to the state, unless the director is removed with cause.

2.1.2 Who can be *de iure* director

As a general principle, all individuals who are able to act under the law (*capacita' d'agire*)[84] can serve as directors in a public company in Italy. There are no restrictions based on the nationality of the director, providing that the condition of reciprocity is respected.[85]

There are exceptions to this rule. Directors cannot be appointed (*ineleggibili*) and, if appointed, are not entitled to remain in office (*causa di decadenza*) if incapacitated, interdicted by court order, bankrupt, or disqualified (even on a temporary basis) from working in public offices or from carrying out managerial roles following a criminal conviction.[86] On the same basis (*ineleggibilita'* and *decadenza*), the articles may impose additional requirements of competence, independence and respectability (*onorabilita'*) in accordance with the corporate governance codes drawn up by regulated stock exchanges or by trade associations.[87]

Special exceptions apply to directors in listed companies. When the default traditional corporate governance model is adopted,[88] at least one of the members of the board of directors, or two if the

[78] Arts. 2383 (2) (3) and 2409 (4) (5) *novies* Civil Code.
[79] Significant exceptions to this rule are set in the area of corporate finance – eg. allotment of shares or convertible bonds (Art. 2443 and 2420 *ter* Civil Code).
[80] Art. 2381 (2) Civil Code.
[81] Art. 2383 (4) Civil Code.
[82] Art. 2383 (3) Civil Code and 2409 (5) *novies* Civil Code under the two-tier model.
[83] Art. 2449 Civil Code.
[84] Art. 2 (1) Civil Code.
[85] Art. 16 Disposizioni sulla legge in generale – Civil Code; on the reciprocity rule see, among other : *Conservatore Registro Parma* (Companies Registrar Parma) 7 September 2010, n. 194 in *Le Società,* 2011, 157.
[86] Art. 2382 Civil Code.
[87] Art. 2387 Civil Code. See also the special requirements imposed on 1/3 of directors under a one-tier model - Art. 2409 (2) *septiesdecies* Civil Code.
[88] A similar regulation operates for the two-tier model (see Art 143 *quarter* CFSA), but not the one-tier model where Art. 2409-*septiesdecies* Civil Code continues to apply.

board is composed of more than seven members, should meet the independence test set out for statutory auditors,[89] and, if provided for in the articles, the additional requirements established in the codes of conduct drawn up by regulated stock exchanges or by trade associations.[90] When the independence tests are no longer satisfied, the director has to notify immediately the board of directors and cannot stay in office.[91]

An area of legal uncertainty following the enactment of the company law reform in 2003 is the question of whether a company can serve as a director in another company. This was regarded to be illegal in the past[92] for a number of controversial reasons based on appointment rights/directors' (individual) accountability,[93] on the substantial departure from the traditional model for public companies set out in the Civil Code[94] and the *de facto* introduction of a new (limited) liability regime for directors.[95] The scenario has changed after the 2003 company law reform and the prevailing academic view maintains that it is possible for a company to act as a director of another company. This is on the basis that the Civil Code allows public and private companies to become partners in general partnerships (*societa' di persone*)[96] and therefore also directors (please note that under Italian law, all directors of general partnerships must also be partners[97]).[98] Some legal scholars and a shared opinion among public notaries, therefore, argue that a company can become a director of another public or private company, provided that the former selects a specific person to act as a director of the latter.[99]

2.2 *De facto* and shadow directors

Even in the absence of a normative definition, it is undisputed under Italian law that a *de facto* director (*amministratore di fatto*) is a person who acts as a director without being properly appointed. The terms of his possible liability are, however, controversial.

The notion of a shadow director (*amministratore ombra*) as a person, in accordance with whose directions or instructions the directors of the company are accustomed to act, is unknown under Italian law. There is no distinction between the cases where someone who is not a *de iure* director acts directly or indirectly as a company director; in both cases he/she qualifies as a *de facto* director (*amministratore di fatto*).[100]

[89] Art 148 (3) CFSA.
[90] Art 147 (4) *ter* CFSA.
[91] Art 147 (4) *ter* CFSA.
[92] See the overview offered by S Rizzini Bisinelli and S Lopatriello 'Amministratore di S.p.A. persona giuridica: spunti di riflessione' (2000) Societa' 1171.
[93] See E Gliozzi 'Societa' di capitali amministratore di societa' per azioni' (1968) Rivista delle Societa' 138. This view is not shared by A Busani and S Pertoldi 'La nomina di soggetti diversi dalle persone fisiche alla carica di amministratore di societa' di capitali' (2006) Notariato 693.
[94] See G Ferri *Le società* (Utet Torino 1996) 678.
[95] See G Cottino *Diritto commerciale* (Cedam Padova 1976) 657.
[96] Art. 2361 (2) Civil Code. See A Bartalena 'la partecipazione di societa' di capitali in societa' di persone' in P Abbadessa and GB Portale (eds) *Il nuovo diritto delle societa*' – Liber Amicorum Gian Franco Campobasso (Utet Torino 2006) 99.
[97] Art. 2257 Civil Code and F Galgano *Amministratori di societa' personali* (Cedam Padova 1963) 101.
[98] See M Stella Richter 'Commento agli artt. 2326-2328' in Marchetti, Bianchi, Ghezzi, Notari (eds) *Commentario alla Riforma delle Societa'* (Giuffre Milano 2008) 119; F Platania *Partecipazione di societa' di capitali in societa' di persone* (Giuffre Milano 2005) 196 and U Tombari 'La partecipazione di societa' di capitali in societa' di persone come nuovo modello di organizzazione dell'attivita' d'impresa' (2006) Rivista delle Societa' 185.
[99] See Society of the public notaries of Milan, 18 May 2007, n. 100.
[100] N Abriani 'Dalle nebbie della finzione al nitore della realta': una svolta nella giurisprudenza civile in tema di ammnistratore di fatto' (2000) Giurisprudenza Commerciale 167.

3 The scope of directors' duties under Italian law

General

Directors of Italian public companies owe fiduciary duties to the company but they are not the company's agents (*mandatari*).[101] They stand in a contractual relationship with the company and their duties of promoting the company's interest (*interesse sociale*) qualify as *obbligazioni di mezzi* (broadly, obligations which should be fulfilled with competent effort), rather than *obbligazioni di risultato* (broadly, obligations which require the obligor to achieve a specific result).[102]

The legal roots that underpin the regulation of directors' duties can be found in the fundamental principle set out under ss 1175 and 1375 Civil Code that requires the obligor to act in good faith when fulfilling contractual obligations.[103] This fundamental principle is particularly relevant for describing the duty of loyalty or the duty to act on behalf (for the interest) of the company. More will be said on this issue below.

3.1 Types of directors' duties

3.1.1 Duty of loyalty

3.1.1.1 Duty to act in the interest of the company (dovere di perseguire l'interesse sociale)

Directors' duty to act in good faith in the interest of the company is generally regarded among commentators[104] and by the courts[105] as a subjective duty. It is based on what the actual director thinks is in the company's best interest and in that respect courts are prevented from reviewing it on different grounds. Moreover, the court's review of the decision considers the company's interests at the time the decision was made.[106]

[101] This has changed with the 2003 company law reform. In the past, directors acted as the company's agents (see article 2391 (2) Civil Code pre-2003).
[102] See L Mengoni 'Obbligazioni «di risultato e obbligazioni di mezzi»'(1954) Rivista di Diritto Commerciale 374 and R Weigmann 'Responsabilita' e potere legittimo degli amministratori (Giappichelli Torino 1974) 164.
[103] See M Bianca ''La nozione di buona fede quale regola di comportamento contrattuale' (1983) Rivista di Diritto Civile 205.
[104] See Fre 'Societa' per azioni, art 2932' in *Commentario Scialoja Branca* (Zanichelli Bologna 1977) 838 and R Weigmann *Responsabilita' e potere legittimo degli amministratori* (Giappichelli Torino 1974) 177.
[105] See App Roma 14 march 2000 (2000) Societa' 969.
[106] Trib Milano 10 february 2000 (2001) Giurisprudenza Commerciale 327. On this issue, see the commentary by A Tina 'Insindacabilità nel merito delle scelte gestionali degli amministratori e rinuncia all'azione sociale di responsabilità' at 334.

3.1.1.2 No conflict rules

3.1.1.2.1 Self dealing regulation

Prior to the 2003 company law reform, Article 2391 of the Civil Code regulated self-dealing transactions in private and public companies in this way: where a director had an interest that conflicted with the interest of the company, it imposed on him the duty to declare the nature of the interest both to the other directors and to the statutory auditors. Article 2391 of the Civil Code also required the same director not to take part in the board meeting at which the matter was considered.

The reformed Article 2391 of the Civil Code has a far-reaching scope of application as it imposes on a director a duty to declare the nature and the extent of any interest that he has (directly or indirectly) in a proposed transaction with the company.[107] Additionally, directors of listed companies have to inform the board of auditors every three months of any transaction in which they have an interest, for their own account or on behalf of third parties.[108] Finally, article 2391 of the Civil Code states that the interested director can attend and vote at the board meeting,[109] provided that the board's resolution appropriately (*adeguatamente*) justifies the reasons and the opportunity for entering into the transaction.

In case the resolution taken by the board proves to be potentially harmful to the company's interests (*danno potenziale*), such decision is voidable[110] when the vote of the interested director was essential for passing the resolution (*prova di resistenza*) or when the board did not adequately justify the reasons and the opportunity for entering into the transaction.[111]

Directors of listed companies in breach of the duty to disclose an interest in a transaction pursuant to article 2391 Civil Code may also face criminal liability (*omessa comunicazione del conflitto di interessi*)[112] if the omission caused damage to the company or to third parties.

3.1.1.2.2 Corporate opportunities

The rule codifying 'corporate opportunities' is set out under Article 2391 (5) Civil Code, which was introduced with the 2003 company law reform.[113] Its sphere of application lies outside the cases where the director has an interest in a proposed transaction with the company. It rather belongs to the situation where the director exploits, for his own benefit or that of third parties, a business opportunity obtained in connection with his managerial position.

[107] Art. 2391 (1) Civil Code also states that the (interested) managing dirctor cannot conlude the transaction, as under these circustances the decision must be taken by the board. On these issues see Zamperetti 'Il <<nuovo>> conflitto di interessi degli amministratori di s.p.a.: profili sparsi di fattispecie e di disciplina' (2005) Le Societa' 1087.

[108] Art. 150 (1) CFSA. In the two-tier model, the same obligation is fulfilled by the management board reporting to the supervisory board and, in the one-tier model, by the bodies with delegated powers reporting to the management control committee – art. 150 (2) CFSA.

[109] Directors' liability is limited to the case where the vote is proved to be essential in passing the board's resolution (Art. 2391 (3) Civil Code). See below.

[110] The rights acquired by good faith purchasers are preserved – Art. 2391 (3) Civil Code.

[111] See M Ventoruzzo 'Art. 2391. Interessi degli amministratori' in P Marchetti, L Bianchi, F Ghezzi and Notari (eds) *Commentario alla riforma delle società* (Milano Giuffre 2005) 498.

[112] Art. 2629 *bis* Civil Code.

[113] Sometimes regarded as a codification of pre-existing case law, according to L Enriques and A. Pomelli '*Articolo 2391*' in A Maffei Alberti (ed) Il nuovo diritto delle società (Cedam Padova 2005) 758 – 778.

In the absence of court decisions, it is questionable from the wording of article 2391 (5) Civil Code whether 'corporate opportunities' have to be in the company's line of business. It is unlikely that this should be the case as article 2391 (5) Civil Code on corporate opportunities would be otherwise redundant and *de facto* a repetition of what was already established by the non-competition rule set out under article 2390 Civil Code.

It is also unclear whether it matters that the director discovered the opportunity outside his office hours. The required 'connection to the appointment' stated in the Civil Code does not seem to be conclusive on the matter.[114]

Briefly, a director is entitled to take a corporate opportunity without breaching article 2391(5) Civil Code when the opportunity is not in the line of business of the company, it has been discovered outside the director's office hours, and, above all, the company is unable to take advantage of the information or opportunity (capability fact).[115] In all other circumstances directors are likely to be held liable for the damage that the company incurs due to the missed opportunity.[116]

3.1.1.2.3 No competition

Article 2390 Civil Code provides that directors, unless authorised by a shareholders' resolution, cannot be members of a competing unlimited liability company, carry out competitive business activities on their own account or for the account of third parties,[117] or be appointed as directors or general managers (*direttori generali*) in competing companies.

Directors' liability is not based on the material negative economic consequences of their actions (i.e. there is no need to give evidence of damages), but on the potential risk that such consequences could occur. It is the fiduciary relationship (no-conflict) with the company that prevails and which is at the basis of liability.[118]

3.1.1.2.4 Related party transactions (*operazioni con parti correlate*)

Directors of listed companies and issuers of financial instruments that, although not listed on a regulated market, are widely held (*societa' che fanno ricorso al mercato del capitale di rischio*)[119] must adopt the necessary procedures to ensure transparency, and substantial and procedural fairness of related party transactions in compliance with the provisions set out by Consob (Art. 2391 Civil Code).[120]

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[114] MC Corradi 'Le opportunita' di affari all'ultimo comma dell'art. 2391 c.c.: profili interpretativi tra <<societa'>> e <<impresa>>' (2011) Giurisprudenza Commerciale 597.

[115] If the company is not capable of taking the opportunity, no damages can be claimed for the missed opportunity.

[116] Although some uncertainty remains, given that case law is lacking. See C Angelici 'Note sulla responsabilita' degli amministratori di societa' a responsabilita' limitata' (2007) Rivista delle Societa' 1217 where the need for Art. 2391 (5) Civil Code in presence of the general rule under Art. 2932 Civil Code is questioned.

[117] This must be on an on-going (and not occasional) basis. See MS Spolidoro 'Il divieto di concorrenza per gli amministratori di societa' di capitali' (1983) Rivista delle Societa' 1318.

[118] See G Minervini *Gli Amministratori di societa' per azioni* (Giuffre' Milano 1956) 195 and L Enriques 'Il conflitto d'interessi nella gestione delle societa' per azioni: spunti teorici e profili comparatistici in vista della riforma del diritto societario' (2000) Rivista delle Societa' 509.

[119] See above sub 1.1.

[120] This is provided in art 4 of Consob Regulations containing provisions relating to transactions with related parties (adopted by Consob with Resolution no. 17221 of 12 March 2010, as amended by Resolution no. 17389 of 23 June 2010), which implements the general principle contained in Art. 2391 (1) *bis* Civil Code (hereinafter the "Regulation on Related Parties Transactions").

These are transactions that involve the transfer of resources, services or obligations between related parties, which are parties linked by a relationship of control, family ties or close corporate influence, as defined by Consob secondary regulation.[121] The necessary procedures to be followed involve, among other things, procedures in order to identify the threshold of importance (*le operazioni di maggiore rilevanza*) in related party transactions,[122] possible waivers,[123] and establish the manner in which related party transactions are executed and approved.[124]

The fundamental principle is that a committee, with a majority of independent directors, must give its opinion on any related party transaction. Additionally, for transactions of high relevance, all committee members must be independent and such committee has to be involved in deciding and negotiating the transaction;[125] in this case, if the committee's opinion is negative, the transaction must be decided on by the general shareholders' meeting.[126]

Finally, the Civil Code imposes an additional layer of regulation by requiring the directors, when filing the explanatory notes (*nota integrativa*) for the companies' annual accounts, to disclose the existence and the terms of the most relevant related party transactions if they are not entered into at standard market conditions (*ex post* disclosure).[127]

3.1.2 Duty of Care

The duty of care is set out in article 2392 (1) Civil Code: a director of a company must exercise his duties with the knowledge, skill and experience that may reasonably be expected of an average director carrying out a similar role (*la diligenza richiesta dalla natura dell'incarico*), and by the specific care and competence that the director has (*le specifiche competenze*).

Similar to s 174 CA 2006, the standard of care imposed by the Civil Code is therefore twofold: an objective one based on the level of care to be expected by a reasonable director in a similar position (the average director) and a subjective one which relies on the additional skills, knowledge and experience that the director has.

The standard of review for business decisions follows a pattern similar to the 'business judgement rule' adopted by Delaware courts.[128] In this respect, the standard for determining whether the director has complied with the duty of care in relation to the decision-making process (*il percorso attraverso il quale la decisione è stata preferita*[129]), even if it is not always neatly traceable in court decisions, is broadly based on a gross negligence standard (*avvedutezza nella gestione*). If directors did act with

[121] See art 1 of Annex 1 Regulation on Related Parties Transactions.
[122] See art 1 of Annex 3 Regulation on Related Parties Transactions.
[123] See art 13 Regulation on Related Parties Transactions.
[124] See art 13 Regulation on Related Parties Transactions
[125] See art 8 Regulation on Related Parties Transactions.
[126] See art 11 (3) Regulation on Related Parties Transactions.
[127] Art. 2427 (1) no 22*bis* Civil Code and 2435 *bis* Civil Code (in the case of non-listed companies) as enacted by Legislative decree no 173 of 2008 which implemented Directive 46/2006/EC.
[128] See G Cabras *La responsabilita' per l'amministrazione delle societa' di capitali* (Utet Torino 2002) 31; M Irrera *Assetti organizzativi adeguati e governo delle societa' di capitali* (Giuffre Milano 2005) 48 and M Cordopatri 'La business judgment rule in Italia e il privilegio amministrativo: recenti correttivi negli USA e in Europa' (2010) Giurisprudenza Commerciale 129.
[129] See Cass 23 march 2004 no 5718 (2004) Rivista del Notariato 1571.

gross negligence,[130] court review of the decision will be on the fairness of the transaction (*vaglio della legittimità della decisione*),[131] otherwise the business judgement rule will apply and courts will subject the decision only to rationality review (*decisione irrazionale o arbitraria*).[132]

Outside the cases where duties are vested in the executive committee or individually in one or more directors,[133] members of the board are jointly and severally liable for the damage caused by a resolution taken in breach of the duty of care.[134] The scope of the provision is to enhance the level of supervision of the board's decision-making process: each of the directors has to monitor that the resolution taken is consistent with the law and take positive action when this is not the case. Liability is, however, excluded when a director's dissenting opinion is recorded in the minutes of the board's meeting and the director notifies in writing the chairman of the statutory auditors of the issue.[135]

Notwithstanding the above, all directors are jointly and severally liable for the damage deriving from their inaction or failure to reduce the consequences of harmful acts of which they had knowledge.[136] This provision contributes to defining the boundaries of the *culpa in vigilando* under the Civil Code and, in doing so, distinguishes it from the pre-existing wider duty to supervise the company's affairs (*obbligo di vigilare sull'andamento generale della gestione*).[137] It needs, however, to be read together with other provisions of the Civil Code, which set out the framework for determining whether a decision is 'informed'.

While the general principle is that directors of a company, when acting, must be well informed about the subject matter of the decision, it is only on the basis of the information received from the delegated managers that they acquire their knowledge. More accurately, under article 2381(3) Civil Code, it is on the basis of the information received that the board of directors evaluates the adequacy of the organisation, management and accounting structure of the company (including strategic/industrial and financial plans when drafted).[138] The possibility of the directors to ask for additional information[139] should not be misleading in this respect: it is a duty connected to the delegated powers and to the information received from the delegated management. It is not an additional general duty of information.[140] In other words, it does not establish a model of strict liability, as the general provision on *culpa in vigilando sub* article 2392 (2) Civil Code was interpreted by the courts before the 2003 company law reform.[141]

[130] Cass 12 november 1965 n. 2359 (1966) Diritto Fallimentare 29; Cass 6 march 1970, n. 558 (1970) Diritto Fallimentare 81; Cass 16 january 1982, n. 280 (1982) Giurisprudenza Italiana I 1 c. 774; Cass 4 april 1998 n. 3483 (1988) Diritto Fallimentare 252; App. Genova 5 july 1986(1987) Giurisprudenza Commerciale 730 and Trib Milano 10 february 2000 (2001) 326. See A Conforti 'Limiti all'accertamento della violazione del dover di diligenza: sono veramente insindacabili le scelte gestionali degli amministratori? (2001) Nuova Giurisprudenza Civile Commentata 224.

[131] See D Monaci 'Sindacato giudiziario della diligenza dell'amministratore e prova dei vantaggi compensativi (2005) Giurisprudenza Commerciale 405.

[132] App. Milano, 28 march 1980 (1982) Giurisprudenza Italiana I, 2, c. 219; App. Milano, 21 january 1994 (1994) Società, 923; Trib. Milano, 9 june 1977 (1977) Giurisprudenza Commerciale 660 and Trib. Milano, 26 May 1989 (1989) Società 970. See R Weigmann 'Responsabilita' e potere legittimo degli amministratori (Giappichelli Torino 1974) 188.

[133] Please note that even in this case, directors will be jointly and severally liable for their inaction when they had knowledge of the breach of the duty of care by one of the other directors (Art. 2392 (2) Civil Code).

[134] Art. 2392 (1) Civil Code.

[135] Art. 2392 (3) Civil Code.

[136] Art. 2392 (2) Civil Code.

[137] Art. 2392 (2) Civil Code pre-2003 company law reform. A comprehensive overview is offered by A Borselli 'Responsabilita' degli amministratori di s.p.a. per violazione dell'onus vigilandi' (2010) Responsabilita' Civile e Previdenza 1349.

[138] Art. 2381 (3) Civil Code. See G Zamparetti *Il dovere di informazione degli amministratori nella governance della societa' per azioni* (Giuffre Milano 2005) 230.

[139] Art. 2381 (5) Civil Code.

[140] See P Montalenti 'La responsabilita' degli amministratori nell'impresa glibalizzata' (2005) Giurispridenza Commerciale 447.

[141] See P Montalenti 'L'amministrazione sociale dal testo unico alla riforma del diritto societario' (2003) Giurisprudenza Commerciale 437; P Abbadessa 'Profili topici della nuova disciplina della delega ammnistrativa' in *Il nuovo diritto delle societa' Liber amicorum Gian franco Campobasso* (Utet Torino 2007) 502 and R Sacchi 'Amministratori deleganti e dovere di agire in modo informato' (2008) Giurisprudenza Commerciale 379.

3.2 Who are the duties owed to?

The Civil Code does not offer a general definition or a list of the company's interests or specific reference to whom the directors' duties are owed. The prevailing view is that directors of a solvent company should act for the benefit of members and that there is no room for a pluralistic approach/enlightened shareholder value approach under Italian law. That said as a general principle, it is also possible that under certain factual circumstances (for reputational reasons with regard to the protection of the environment, for example) the interests of other stakeholders may occasionally be taken into account.[142]

The opposite view, according to which directors while acting should necessarily have regard to the interests of other stakeholders, is not convincing. It is not convincing when examined in light of the enhanced managerial responsibility/autonomy resulting from the 2003 company reform that is purported to have granted directors a greater flexibility in identifying the company's interests.[143] This is simply because there is no evidence in that regard from the preparatory works[144], and the fact that additional special means of protecting stakeholders have not been introduced supports the view that the reforms of 2003 have not brought substantive change in this respect.

It is also not convincing if based on the rationale underlying certain isolated provisions on takeovers contained in CFSA,[145] where it cannot be denied that the shareholders' interests are still the prevailing ones,[146] or general administrative rules on compliance that aim at preventing corporate crimes,[147] as these remain fully consistent with the scope of maximising shareholder value.

The real issue is rather to identify precisely the meaning of shareholder value maximisation in the light of the complexities in distinguishing between the expectations of different types of shareholder. This conundrum has led some Italian academics to identify shareholder value as short-term profit.[148] Others interpret shareholder value as long-term profit of the corporation,[149] as it seems to be confirmed by certain provisions contained in the Corporate Governance Code (*Codice di Autodisciplina*).[150]

3.3 The director as a shareholder

[142] See M Libertini 'Impresa e finalita' sociali. Riflessioni sulla teoria della responsabilita'sociale dell'impresa' (2009) Rivista delle Societa' 25; R Costi 'Responsabilita sociale dell'impresa e diritto azionario italiano' in *La responsabilita' dell'impresa*, Atti del Convegno per i trent'anni di Giurisprudenza Commerciale, Bologna, 8-9 ottobre 2004 (Milano Giuffre' 2006) 91 and PG Jaeger *L'interesse sociale* (Giuffre' Milano 1964).
[143] C Angelici 'La società per azioni e gli "altri", in *L'interesse sociale tra valorizzazione del capitale e protezione degli stakeholders*, Atti del convegno in ricordo di PG Jager (Milano Giuffre 2010) 56.
[144] See R Costi 'L'interesse sociale nella riforma del diritto azionario' in Diritto, mercato ed etica (Egea Milano 2010) 263.
[145] Art 103 (3) *bis* CFSA where is stated that directors' notice containing all information useful to evaluating the bid, must also contain "an evaluation of eventual success of the takeover bid on the interests of the company, and on the employment conditions and location of business premises".
[146] See V Calandra Bonaura 'responsabilita' sociale dell'impresa e doveri degli amministratori' (2011) Giurisprudenza Commerciale 526.
[147] Eg. Legislative decree no 231 of 2001.
[148] F Denozza and A Stabilini 'CSR and Corporate Law: The Case for Preferring Procedural Rules' (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1117576 (accessed 20 February 2012)
[149] F Denozza and A Stabilini 'CSR and Corporate Law: The Case for Preferring Procedural Rules' (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1117576 (accessed 20 February 2012).
[150] 7.p.2.: "The remuneration of executive directors and key management personnel shall be defined in such a way as to align their interests with pursuing the priority objective of the creation of value for the shareholders in a medium-long term time frame' seems to point out in the opposite long-term direction.

A director may well be also a shareholder in the same company. His duties to the company apply only when he acts as director.

3.4 The time span of the duties

As a general rule, directors' duties commence at the date of the acceptance of their appointment[151] and they last until the acceptance of the appointment of the new directors at the end of the term.[152]

There are a number of exceptions to this rule. When a director renounces his office before the end of the term, his renunciation is immediately effective if a majority of the board of directors remain in office, or otherwise from the time when a majority of the board has been formed following the appointment of the new directors.[153] In all other circumstances when the consequences of the end of office are immediate (e.g. death, removal) a distinction should be drawn depending on whether the majority of the directors in office are still the ones appointed by shareholders' resolution or not. In the former case, the remaining directors may provide for their immediate replacement by resolution approved by the statutory auditors with validity until the following general meeting.[154] In the latter case, the remaining directors have to call a general meeting. Unless otherwise stated in the articles or in the shareholders' resolution, the term of office of the directors so appointed expires at the same time as those already in office.[155]

3.5 Application of duties to *de facto* and shadow directors

While the Civil Code states that shadows directors are subject to criminal liability in the same manner as *de iure* directors,[156] the pattern for establishing civil liability is not clear and, in this respect, a distinction must be drawn between private and public companies.

In the case of private companies, the law is conclusive only when the *de facto* director is also a shareholder and he actively takes part in the decision-making process, but it is silent in all other circumstances. Under article 2476 (7) Civil Code, only members who have intentionally decided or authorised certain actions that proved to be harmful for the company (*atti dannosi per la societa'*) are jointly and severally liable with the (*de iure*) directors.

In all other circumstances and in the case of public companies, the academic perception is not always consistent with the view endorsed by the courts. One approach is guided by the need to promote substantial justice,[157] which finds its roots in the analogy of a *de facto* director's liability with that of the general managers (*direttori generali*)[158] or, possibly, with the rules on *negotiorium gestio*.[159] The

[151] Art. 2283 (1), 2285 (1) and 2386 (1) Civil Code.
[152] Art. 2385 (1) Civil Code.
[153] Art. 2385 (1) Civil Code.
[154] Art. 2386 (1) Civil Code.
[155] Art. 2386 (3) Civil Code.
[156] Art. 2639 Civil Code.
[157] See N Abriani *Gli amministratori di fatto delle societa' di capitali* (Giuffre Milano 1998) 216, partly followed in the cases (Cass 6 march 1999 n 1925 (2000) Giurisprudenza Italiana 770 and Cass 14 August 1999 n 9795 (2000) Giurisprudenza Commerciale 167).
[158] See A Borgioli 'Amministraori di fatto e direttori generali' (1975) Giurisprudenza Commerciale 525.

second, more formalistic, view,[160] which was followed by the courts in the past,[161] argues that adequate protection could be rather achieved by relying on specific mechanisms of company law provided for under the Civil Code (e.g. article 2497 Civil Code on control in corporate groups).[162]

[159] See F Guerrera 'Gestione di fatto e funzione amministrativa nelle societa' di capitali' (1999) Rivista di Diritto Commerciale 131.
[160] See Cass 12 january 1984 n 234 (1985) Giurisprudenza Commerciale 182 and Cass 19 december 1985 n 6493 (1986) Giurisprudenza Commerciale 813.
[161] See Cass 12 january 1984 n 234 (1985) Giurisprudenza Commerciale 182 and Cass 19 december 1985 n 6493 (1986) Giurisprudenza Commerciale 813.
[162] See G Campobasso *Diritto Commerciale- Diritto delle Societa'* (Utet Torino 2006) 389.

4 LIABILITY FOR BREACH OF DUTY

4.1 Conditions for liability

Directors' liability arises when there is a breach of a duty (*inosservanza dei doveri*) set out in the law or in the articles, and a loss (*danno*) has occurred to the company as the consequence of the breach.[163] The burden of proof varies depending on whether the claim is brought by the company, by shareholders in the company's name, by creditors or by individual shareholders in their own name (on this issue see below the paragraph 'enforcement of directors' duties').

4.2 Exemptions and limitations

The rules on directors' duties under the Civil Code are mandatory. In other words, the conventional view is that public companies are not allowed to exempt a director for liability in connection with the breach of the duties to which he/she is subject.[164] A more flexible approach argues that according to the general rules in contract law, exemptions should be allowed in case of breaches of negligible importance (*colpa lieve*)[165] and there is no veto by qualified minority shareholders under article 2393 and 2393*bis* Civil Code (see below).[166]

However, provided that there is not a qualified opposition from shareholders representing one fifth of the outstanding capital or a different percentage as set out in the articles,[167] the claim brought by the company against the directors pursuant to article 2393 and the derivative claim pursuant to article 2393*bis* Civil Code can be waived or settled before the starting of court proceedings by ordinary resolution or, in the case of a derivative claim, by the same members who have brought it.[168]

[163] Arts. 2392 (1) and 2391 (4) Civil Code.
[164] See Fre-Sbisa' 'Della società per azioni, I, Artt. 2325-2409' in Scialoja and Branca (eds) *Commentario del codice civile* (Zanichelli Bologna-Roma 1997) 847.
[165] See Art. 1229 Civil Code.
[166] A comprehensive analysis on both positions is offered by A Tina *L'esonero da responsabilita' degli amministratori di s.p.a.* (Giuffre Milano 2008) 87.
[167] Art. 2393 (6) Civil Code. In the case of listed companies and the ones that, although not listed on a regulated market, have shares widely distributed among the public (*societa' che fanno ricorso al capitale di rischio*) the opposition from shareholders should represent at least one twentieth of the outstanding corporate capital or such different percentage as indicated in the articles – Art. 2393 (6) Civil Code (before the 2003 company law reform, the rule was set out in art 129 CFSA). See G Oppo 'La nuova legislazione commerciale. L'azione << sociale>> di responsabilita' promossa dalla minoranza nelle societa' quotate' (1988) Rivista di Diritto Civile 405; MM Ricossa 'Art 129 Azione sociale di responsabilita'' in G Cottino (ed) *La legge Draghi e le societa' quotate in borsa* (Utet Torino 1999) 168; FM Mucciarelli 'L'azione sociale di responsabilita' contro amministratori di societa' quotate' (2000) Giurisprudenza Commerciale 59 and P Benazzo *Rinuncia e transazione in ordine all'azione sociale di responsabilita*' (Cedam Padova 1992) 332.
[168] Art. 2393 (6) *bis* Civil Code.

4.3 Insurance against liability

It is possible for a company to pay an insurance premium pursuant to art. 1891 Civil Code[169] (*assicurazione per conto altrui*) for the benefit of a director to cover the risk of breach of fiduciary duties. While protection is often available in the case of claims brought by creditors[170] and individual shareholders (see below the paragraph on enforcement of directors' duties),[171] this is rarely available in practice against claims brought by the company.[172] Academics have argued that D&O availability may lower the deterrence effect of the liability provisions, but this view is only partly correct, as events caused by intentional misconduct are not insurable pursuant s 1900 (1) Civil Code (*non sono assicurabili gli eventi cagionati con dolo del contraente, dell'assicurato o del beneficiario*)[173] and in most cases there is a threshold to limit the insured amount (*massimale*).[174]

4.4 Consequences of liability

When a board's resolution has not been taken in compliance with the law or the articles, such decision can be challenged by statutory auditors, by the directors who did not attend the meeting or by those who registered their dissenting views within 90 days from the date of the resolution.[175] A void resolution will not affect the rights acquired by a third party dealing with the company in good faith.[176]

The shareholders' resolution that directs the board to commence litigation in relation to an alleged breach of a director's duty vis-à-vis the company (*azione sociale di responsabilita'* – see below 6.1.1.1.) causes the immediate removal of the said director if it is passed with the favourable vote of shareholders representing 1/5 of the outstanding corporate capital. Directors are contractually liable (Art. 1218 Civil Code) for the damage incurred by the company if the decision to commence litigation in relation to an alleged breach of directors' duties is taken by the company or following a derivative action (see below 6.1.1 and 6.1.2.). and for the damage caused to the integrity of the patrimony if the decision is taken by creditors (see below 6.1.2.3.). Directors will be liable in tort (Art. 2043 Civil Code) for the loss caused when their decisions have harmed exclusively the interests of an individual shareholder or a third party (see below 6.1.2.4.).

[169] See G Santini 'Proposte per un'assicurazione <<all risks>> degli amministratori di societa' (1985) Giurisprudenza Italiana 465.
[170] Art. 2394 Civil Code.
[171] Art. 2395 Civil Code.
[172] Art. 2392 Civil Code. See U Tombari 'Assicurazione della responsabilita' civile degli amministratori di societa' per azioni' (1999) Banca, Borsa e Titoli di Credito 180.
[173] G Scalfi *Manuale delle Asscurazioni Private* (Egea Milano 1994) 197.
[174] M Casella and R Ruonzi *Gli amministratori* (Egea Milan 1997) 65.
[175] Art. 2388 (4) Civil Code in the case of the traditional and one-tier model and Art. 2409 *undecies* (2) Civil Code in the case of the two-tier model.
[176] Art. 2388 (5) Civil Code in the case of the traditional and one-tier model and Art. 2409 *undecies* (2) Civil Code in the case of the two-tier model.

5 Duties in the Vicinity of Insolvency

When the company is close to insolvency and not able to meet its financial obligations as they fall due, directors face significant limitations in their managerial autonomy.[177] They have to act primarily in order to protect the integrity of the company's assets (*conservazione dell'intergrita' del partimonio sociale*), even by promoting debt restructuring[178] or by implementing a liquidation procedure.

Directors' liability for breach of their duties will be based on criminal law liability for 'wrongful trading' (*bancarotta semplice*) if the company's business does not have any prospect of recovery and notification of insolvency should have been presented to the courts (s 217 (1) no 4 Insolvency Act (*Legge Fallimentare*), or on 'fraudulent trading' (*bancarotta fraudolenta* according to s 217 (1) no 1 and 2 *Legge Fallimentare*) if the directors' decisions have been taken with the intent to defraud creditors. However, under both scenarios, liability originates only once the status of insolvency has been declared by the court (*condizione obiettiva di punibilita'*).

Directors may also face criminal charges for having borrowed financial resources from lenders at a time when they were aware of the proximity to insolvency and concealed that status to the lenders (*ricorso abusivo al credito* – s 218 *Legge Fallimentare*). In this case there is no need for an official declaration of insolvency from the court.[179]

Finally, directors' liability is possible under article 2486 Civil Code if they did not act to preserve the integrity of the company's assets even if there is a reason for liquidation (*causa di scioglimento*).[180]

5.1 The meaning of 'vicinity of insolvency'

The definition of insolvency according to s 5 of *Legge Fallimentare* is very broad, but it gives some general guidelines on what 'vicinity of insolvency' (*stato di insolvenza*) may possibly mean. More precisely, insolvency is described either as the company's inability to regularly meet its financial obligations when they fall due or the existence of certain evidence that shows that the company will not be able to fulfil its obligations in the future. With regard to the latter, Italian law provides that it is only possible to apply to the court by petition for starting an insolvency proceeding when the amount of the existing unpaid debts is greater than 30,000.00 Euros, and certain specific accounting/monetary thresholds are met (s 1 (2) *Legge Fallimentare*).

[177] G Ferri 'Impresa in crisi e garanzia patrimoniale' in Abriani (ed) *Diriitto fallimentare, Manuale Breve* (Giuffre Milano 2008) 31.
[178] See A Vicari 'I finanziamenti delle banche ai fini ristrutturativi' (2008) Giurispudenza Commenrciale 478.
[179] Andrelli 'La riforma della legge fallimentare : i riflessi penali' (2006) Cassazione Penale 1299 and G Lunghini 'Falso in bilancio e altri reati a tutela del risparmio: le novita' penali ed amministrative' (2006) Diritto e pratica delle Societa' 60.
[180] See Art. 2484 Civil Code (e.g., share capital below the minimum requirement or deadlock in the functioning of the company).

5.2 Change of existing duties

Under Italian law, it is difficult to see exactly when a director can be considered to have a duty to protect the interests of creditors before (some or all of) the requirements for an insolvency declaration (see above) are present.

5.3 Newly arising duties

The duty to protect the integrity of the company's assets for the benefit of the creditors prevails over the ordinary directors' duties in the vicinity of insolvency. The nature of this duty is based on criminal law and the source is in the *Legge Fallimentare*. See above.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue

6.1.1 The company as a plaintiff

6.1.1.1 Shareholders' resolution (azione sociale di responsabilita' promossa dalla societa')

The default rule under the Civil Code is that, even if a public company is subject to liquidation, shareholders, by way of ordinary resolution, can direct the board[181] to commence litigation in relation to an alleged breach of a director's duty vis-à-vis the company.[182]

6.1.1.2 Decision by board of auditors or supervisory board

Alternatively, following a recent amendment of the Civil Code,[183] the board of statutory auditors is entitled to take such decision by a qualified majority of two thirds of the board members.[184] In the case of the two-tier model the right to bring an action against the members of the management board (*consiglio di gestione*) can also (i.e. in addition to ordinary shareholder resolution) be taken following a resolution of the supervisory board (*consiglio di sorveglianza*).[185]

One possible direct consequence of the resolution to commence litigation is the directors' removal. This occurs *ex lege* when the resolution is taken with the favourable vote of shareholders representing one fifth of the corporate capital, or in the two-tier model, two thirds of the members of the supervisory board. In the course of the same meeting new directors are appointed.[186]

The resolution to bring the claim has to be taken within five years since a person ceased to be a director[187] and, being a contractual liability, once a loss following a breach of duty has been shown, the burden of proof (i.e. showing that the subjective element of the liability is not present) will be on the director.[188]

[181] Art. 2393 (1) Civil Code. Unless a different person (*curatore speciale*) has been appointed for the scope – section 78 (2) Civil Procedure Code.
[182] Art. 2364 (1) no 4 Civil Code. Interested directors cannot vote in this case – Art. 2373 (2) Civil Code.
[183] Enacted pursuant to law no 262 of 2005.
[184] Art. 2393 (3) Civil Code.
[185] Art. 2409 (2) *decies* Civil Code.
[186] By ordinary resolution or by the members of the supervisory board, respectively. See Art. 2393 (5) and 2409 (2) *decies* Civil Code.
[187] Art. 2393 (4) Civil Code (traditional and one-tier model) and 2409 (3) *decies* Civil Code (two-tier model).
[188] Art. 1218 Civil Code.

6.1.2 The shareholders as a plaintiff for breach of fiduciary duties *vis-à-vis* the company

6.1.2.1 Derivative action (azione sociale di responsabilita' promossa dai soci)

The Civil Code allows a group of shareholders representing at least one fifth of the outstanding corporate capital or a different percentage as set out in the articles (which cannot exceed in any case one third of the corporate capital), to enforce[189] the company's rights against the directors.[190] In bringing a derivative action, shareholders act on behalf of the company, so that the award will compensate only the company for its loss. If the claim is successful the company will indemnify the claimants against the costs incurred in bringing the proceedings, unless the costs are imposed on the losing party or the losses can be recovered upon direct enforcement against that party.[191] However, if the claim is settled or is not successful, the claimants do not have any right to indemnification of any expenses occurred.

Again, the decision has to be taken within five years since a person ceased to be a director[192] and, being a contractual liability, once a loss following a breach of duty has been shown, the burden of proof will be on the director.[193]

6.1.2.2 Judicial supervision and right to report to the court (Denunzia al tribunale)

Article 2409 Civil Code allows a group of shareholders, representing at least one tenth of the outstanding corporate capital or one twentieth in the case of listed companies and issuers of financial instruments that, although not listed on a regulated market, are widely distributed among the public (*societa' che fanno ricorso al capitale di rischio*[194]), to notify the courts on the suspicion that directors have breached their duties and caused serious irregularities (*gravi irregolarita'*) in the management of the company. If the claim is proved and remedies are not put in place, the court is entitled to remove the existing board of directors.[195]

6.1.2.3 Liability vis-à-vis- creditors

The Civil Code provides a peculiar form of a duty owed to the creditors under article 2394, according to which directors are liable vis-à-vis creditors when the integrity of the company's assets (*conservazione dell'intergrita' del patrimonio sociale*)[196] has not been duly preserved. This provision typically applies when the company is insolvent. Indeed, article 2394 *bis* of the Civil Code explicitly provides that the same claim may be brought by the liquidator when the company is wound up.[197]

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[189] Art. 2393 (3) bis Civil Code.
[190] Art. 2393 (1) *bis* Civil Code. In the case of listed companies and companies that, although not listed on a regulated market, are widely distributed among the public (*societa' che fanno ricorso al capitale di rischio*) the claim may be brought by a group of shareholders representing at least one fortieth of the outstanding corporate capital or such different percentage as indicated in the articles – Art. 2393 (2) *bis* Civil Code.
[191] Art. 2393 (4) *bis* Civil Code.
[192] Art. 2393 (4) Civil Code (traditional and one-tier model) and 2409 (3) *decies* Civil Code (two-tier model).
[193] Art. 1218 Civil Code.
[194] See above sub 1.1.
[195] Art. 2409 (4) Civil Code.
[196] Art. 2394 Civil Code.
[197] See E Cicconi 'L'azione di responsabilita' contro amministratori, sindaci, liquidatori e direttori generali di societa'' (1998) Giustizia Civile 523.

According to certain court decisions and a number of legal scholars, directors are liable in tort vis-à-vis the creditors[198] and, therefore, creditors need to provide evidence of directors' negligence. By contrast, according to the view of other legal scholars, supported by a significant set of case law, directors' liability is based on contract. Once it is shown that directors have breached their duty to preserve the integrity of the company's patrimony, the burden of proof (i.e. showing that the subjective element establishing the liability is not present) will be on the directors.[199]

This duty originates when shareholders have not brought a claim against a director or, if that is the case, the claim has later been settled (but not when it has been waived[200]). Although the matter is still debated in the legal literature and before the courts,[201] the prevailing view is that this is *de facto* a right of subrogation granted to creditors when it is doubtful that the company's assets will be sufficient to meet the creditors' repayment rights.[202]

6.1.2.4 Directors' liability vis-à-vis individual shareholders and third parties

In the case that certain decisions taken by directors do not harm the company's interests in general, but exclusively affect the interests of an individual shareholder or of a third party, the Civil Code allows the victim to sue the directors within five years[203] from the occurrence of the wrong (*responsabilita' extracontrattuale*) allegedly committed by the directors. Under these circumstances, it will be for the individual member or the third party to prove both the personal loss/damage and the connection with the wrong caused by the director.[204]

6.2 Criminal and administrative sanctions

A number of criminal law provisions relating to the directors' behaviour are contained in the Civil Code, which stem from the implementation of legislative decree no 61 of 2002. They include various sections, which all find their roots in the breach of directors' duties described above. Among the most significant are the delivery of false statements to the company (*false comunicazioni sociali*)[205] or to third party auditors (*falsita' nelle relazioni o nelle comunicazioni della societa' di revisione*),[206] depending, in the former case, on whether the company is listed or a harmful event has occurred, the unlawful distribution of profits and reserves (*illecita ripartizione degli utili e dei dividendi*), failure to call a shareholders' meeting (*omessa convocazione dell'assemblea*),[207] and financial fraud (*infedelta' patrimoniale*).[208]

[198] Cass., n. 13765/2007. Galgano / Genghini, *Il nuovo diritto societario* (Torino, Utet, 2006) 290.
[199] See A Auditori *Funzione amministrativa e azione individuale di responsabilita* (Milano Giuffre 2000) 68 where a number of cases that share this interpretation are also reported.
[200] Article 2394 (3) Civil Code, for the self-evident reason that the integrity of the assets has not been restored under that circumstance.
[201] Cassazione n. 13765/2007 and n. 10488/1998; among legal scholars see: Campobasso, *Diritto Commerciale – Diritto delle società* (Utet, Torino, 2012) 400 (with further references).
[202] See G Minervini *Gli amministratori di societa' per azioni* (Giuffre Milano 1956) 329.
[203] Art. 2395 (2) Civil Code.
[204] See Cass 6 january 1982 (1983) Giurisprudenza Commerciale 430 and Cass 3 december 2002 (2003) Foro Italiano 2438.
[205] Arts. 2621 and 2622 Civil Code.
[206] Art. 2624 Civil Code.
[207] Art. 2631 Civil Code.
[208] Art. 2634 Civil Code.

While civil law provisions set out directors' standards of behaviour by generic reference to the law or to the articles,[209] criminal law identifies specific rules with clear boundaries in observance of the criminal law principle of *nulla poena sine lege* and its corollary that requires accuracy and precision in drafting (*principio della tassativita'*).[210] Needless to say that all criminal law provisions are also sources of civil law liability.

[209] Art. 2392 (1) Civil Code.
[210] Art. 1 Penal Code and art 25 (2) Italian Constitution.

7 Conflict of Laws

7.1 Classification under Italy's private international law

Italy has adopted a compromise position between the 'real seat' and 'incorporation' theories on conflict of laws. As a general principle, pursuant to the first part of article 25 (1) of Law no 218 of 1995, companies, associations, foundations and any other (public or private) entity are governed by the state in whose territory the procedure of formation is perfected. Consequently, Italian law follows the 'incorporation theory' of conflict of laws and companies formed in Italy are subject to Italian law. However, the second part of article 25 (1) of Law no 218 of 1995 provides an additional 'real seat' choice of law rule. Notwithstanding the principle set out in the first part of article 25 (1) of Law no 218 of 1995, Italian law applies also if the seat of the administration or the principal office of the entity is located in Italy. It follows that even if companies are incorporated abroad, they may still be subject to Italian law when significant elements of connection with the Italian territory are found.[211] Following the recent development of ECJ decisions starting with Centros, it goes without saying that apart from exceptional circumstances (*norme di applicazione necessaria*) the connecting factor described in the second part of article 25 (1) of Law no 218 of 1995 will be applicable only with respect to non-EU companies.

Finally, article 25 (2) of Law no 218 of 1995 identifies all the issues and matters that are regulated by the law governing the company. In particular, these are the formation, powers, and functioning of the company's organs,[212] including the directors' rights and obligations.[213] A discussion on freedom of establishment granted to companies by Articles 43 and 48 of the EC Treaty and its implications is beyond the scope of this report on directors' duties.[214]

7.2 Tort law

Article 25 (1) and (2) of Law no 218 of 1995 encompass all issues and matters that are regulated by the law governing companies, including the functioning of the company's organs and directors' rights and obligations. Therefore, the conflict of laws principles discussed above extend to non-contractual obligations and in particular tortuous liability. Regulation (EC) no 864/2007 on the law applicable to non-contractual obligations (Rome II) does not apply to companies and the personal liability of officers.[215]

[211] See M Benedettelli 'La legge regolatrice delle persone giuridiche dopo la riforma del diritto internazionale privato' (1997) Rivista delle Societa' 38 and G Ramondelli 'L'attuale d.i.p. italiano in materia di società e sua influenza in sede di omologazione' (1996) Rivista del Notariato 1406.
[212] Article 25 of Law no 218 of 1995, lett (e).
[213] Article 25 of Law no 218 of 1995, lett (g).
[214] A general overview of Italian law is offered by T Ballarino 'Sulla mobilita' delle societa' nella Comunita' Europea. Da Daily Mail a Uberseering: norme imperative, norme di conflitto e liberta' comunitarie (2003) Rivista delle societa' 723. See also Gildea A.J. "Uberseering: A European Company Passport", Brooklin International Law Journal, Vol. 30.1., 2004, p. 257-292 and, recently, G Gerner Beuerle and M Schilling 'The Mysteries of Freedom of Establishment after Cartesio'(2010) International & Comparative Law Quarterly and F Mucciarelli 'Companies' Emigration and EC Freedom of Establishment' available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1078407&rec=1&srcabs=1340964 (accessed 12 April 2012).
[215] Article 1 (2) (d) Regulation (EC) no 864/2007.

7.3 Special duties in the vicinity of insolvency

Articles 4 and 5 of Council Regulation (EC) 1346/2000 on collective insolvency proceedings are not relevant with respect to decisions taken by directors before the commencement of insolvency proceedings.

DIRECTORS' DUTIES AND LIABILITY IN LATVIA

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CONTENTS

1 Introduction

1.1 Corporate law and directors' duties in Latvia

The framework of Latvian company law is based on principles of private law, recognition of the private contracting, and it is reflected in the legislation addressing the commercial activity. The understanding of the Latvian company law was developed to a large extent already during the thirties of the 20th century with the adoption of a number of statutory instruments. Yet, the Latvian legal system has gone through a phase of sweeping changes during the nineties, just after the collapse of the Soviet Union, when Latvia renewed its independence. It required redesigning the legal system as a result of which the architecture of private law was made to a large extent in the traditions of dualism. Thus commerce and *inter alia* also company law was seen as a 'specific part of private law' and therefore was codified in statutory instruments separate from the civil law.[1]

Currently the company law is contained in the Commercial Law[2] (*Komerclikums*) adopted in 2000 and coming into force in 2002. The Civil Law[3] (*Civillikums*) is applicable to business only as far as the Latvian commercial law does not cover the particular issue. Thus, the provisions of the Latvian Civil Law are used for 'gap-filling' in the Latvian commercial law.[4]

Before adoption of the Commercial Law, the Company law was addressed by an umbrella law regulating the entrepreneurship in general[5] and addressing private limited liability companies[6] and public limited liability companies[7] by separate pieces of legislation.

Notwithstanding the fact that the Commercial Law provides a general framework for understanding of directors' duties there is very little case law addressing and interpreting this concept. At the same time and especially in light of the recent collapse of the bank AS Latvijas Krājbanka, the issue of directors' duties and a broader discussion about corporate governance were brought to a spotlight. However, the discussion is rather oriented towards legal practice and business which explains the lack of academic writings about this topic.

1.2 Corporate Landscape

The Commercial Law is divided into four parts:

- Part A sets a general framework for commercial activity;
- Part B regulates business entities registered at the Commercial Register;

[1] Kalvis Torgāns, *Current Topics on Civil, Commercial law and Civil Procedure. Selected Articles 1999-2008* (Tiesu Namu Aģentūra 2009) 307-310
[2] Commercial Law, 2000 (*Komerclikums*)
[3] Civil Law, 1937 (*Civillikums*)
[4] Aigars Strupišs, *Komerclikuma komentāri. A daļa Komercdarbības vispārīgie noteikumi (1.-73. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 30-33
[5] Law on Entrpreneurship, 1990 (*likums „Par uzņēmējdarbību")* not in force
[6] Law on Private Limited Liability Companies, 1991 (*likums "Par sabiedrībām ar ierobežotu atbildību")* not in force
[7] Law on Joint Stock Companies, 1993 (*likums "Par akciju sabiedrībām")* not in force

(i) an individual merchant (*Individuālais komersants* or *IK*);

(ii) partnerships (*Personālsabiedrība*) which are divided into general partnerships (*Pilnsabiedrība*) or limited partnership (*Komandītsabiedrība* or *KS*); and

(iii) limited liability companies (i.e. companies limited by shares) which are divided into private limited liability companies (*Sabiedrība ar ierobežotu atbildību* or *SIA*) and public limited liability companies (*Akciju sabiedrība* or *AS*).

- Part C regulates reorganisation of partnerships, private and public limited liability companies and cross-border mergers; and
- Part D addresses commercial transactions, i.e. transactions where one of the contracting parties is the entity registered at the Commercial Register.

Corporate insolvency is an issue not covered by the Commercial Law but provided in the Law on Insolvency.[8]

Chapter XI of the Commercial Law regulates general issues of limited liability companies and *inter alia* also the liability issue. Thus it sets also the standard for directors' duties. Specific issues of each corporate form of limited liability companies are respectively covered by Chapter XII for private limited liability companies and by Chapter XIII for public limited liability companies. In addition, companies operating in the regulated sphere like insurance companies, banks, pension funds, investment funds, are subject to a supervision of the Financial and Capital Markets Commission and are subjected to a special legislation addressing each of the mentioned spheres separately. It may impose more tailor-made duties on the directors and thus also more specific expectations driven by the industry practice. Another very specific type of company is where all or part of the shares are held by the state or the municipality.[9]

Public limited liability companies whose shares are publicly traded are also subject to the Financial Instrument Market Law[10] (*Finanšu instrumentu tirgus likums*) setting the requirement to prepare the report on corporate governance. When preparing this report according to the guidelines for the corporate governance, the companies must follow the 'comply or explain' principle.[11]

Among the companies, a private limited liability company is by far the most popular form of business entities. Currently there are 121,386 active private limited liability companies and 912 public limited liability companies registered at the Commercial Register.[12] Out of all Latvian public limited liability companies, only 32 companies are listed on the stock exchange (Baltic equity list) of NASDAX OMX.[13]

[8] Law on Insolvecy, 2010 (*Maksātnespējas likums*)
[9] Law on State and Municipality Capital Shares and Companies, 2003 (*Par valsts un pašvaldību kapitāla daļām un kapitālsabiedrībām*).
[10] Financial Instrument Market Law, 2004 (*Finanšu instrumentu tirgus likums*)
[11] Principles of Corporate Governance and Recommendations on their Implementation is good example of such *soft law* implemented by the Exchange NASDAQ OMX Riga. http://www.nasdaqomxbaltic.com/files/riga/corp_gov_May_2010_final_EN.pdf , accessed on 15 February 2012
[12] Data from Lursoft statistics; http://www.lursoft.lv/lursoft-statistika/Komercregistra-registreto-komersantu-un-to-filialu-sadalijums-pa-uznemejdarbibas-formam&id=197 , accessed on 20 February 2012
[13] Data from Exchange NASDAQ OMX Riga: http://www.nasdaqomxbaltic.com/market/?pg=mainlist&lang=en, accessed on 20 February 2012

1.3 The board of a Latvian company

The Commercial Law provides for the board structure in the traditions of two-tier structure, where the management board (*valde*) is the active managing body of a company while the supervisory board (*padome*) performs the supervisory or controlling function.

The supervisory board is mandatory only for public limited liability companies, whereas private limited liability companies may choose/opt to have the supervisory board by explicitly stating that in their articles of association. The articles of association must mention an exact number of the management board and supervisory board members.

2 The Concept of company director in Latvia

The notion of a director first of all can be construed through the general rule of the Civil Law about representation which provides that legal persons act through their legal representatives.[14]

Through the representative function the Commercial Law recognises two types of company directors: members of the management board and members of the supervisory board. Following the division of functions in the two-tier structure of the board, only the management board has the representative rights with respect to third parties.[15] While the supervisory board may have the right to approve certain types of business decisions, it does not have the right to represent the company before third parties. The representative function is exercised by the supervisory board only when the company needs to be represented in relations with the management board (for example, in case the company initiates a claim against a management board member or in transactions between the company and the management board member).

It must be noted that even the scope of the management board's authority may be limited by the articles of association or under the statutory rules, granting certain managerial discretion to the supervisory board or the general meeting of shareholders, these limitations exist with respect to the management board's relations with the company and do not affect the management board's capacity to represent the company before third parties as such. Yet, the interaction of the management board's managerial and representative functions becomes important and thus subject to evaluation in the context of directors' liability.

In addition, when a company goes into liquidation, a liquidator takes over the duties and obligations of the management board and supervisory board[16] and may exercise his/her managerial discretion as long as it complies with the objective of the liquidation.[17]

2.1 De iure Directors

2.1.1 Requirements to become de iure director

According to the Commercial Law a person can be considered as *de iure* director if he/she is validly appointed to this position, he/she consents to the appointment and has not resigned from the director's position and no obstacles exist that would prohibit a person to take a director's position. Changes in the composition of the management board or the supervisory board must be filed at the Commercial Register; however with respect to a company the management board members and the

[14] Civil Law 1937, s 1410
[15] Commercial Law 2000, s 221 (1) and s 301 (1)
[16] Commercial Law 2000, s 318 (1)
[17] Commercial Law 2000, s 322 (1)

supervisory board members generally obtain the rights and obligations as of the moment of their election.

Members of the management board of a public limited liability company are elected by the supervisory board[18], while in a private limited liability company the management board members are elected by the general meeting of shareholders[19] irrespective of whether the supervisory board is formed or not. A person may not be elected as a management board or supervisory board member without a written consent.[20] In addition, the Commercial Law provides that the consent of the management board member must be signed either by a secure electronic signature or signed in the presence of a notary public or approved by an official of the Company Register.

Members of the management board and the supervisory board of a public limited liability company are elected for a term of office of maximum five years, unless articles of association provide for a shorter term of office.[21] In private limited liability companies the management board and the supervisory board members are elected for a non-defined term, unless articles of association provide for an exact term of office.[22] In private limited liability companies generally the management board members can be revoked prematurely at any time (provided that articles of association do not provide that an important cause is needed to revoke a management board member). In public limited liability companies management board members may be revoked only for an important cause.[23] The Commercial Law provides for a list what can be considered as an important cause.

In general, the management board of a private limited liability company and public limited liability company may consist of one member; however, if shares of the public limited liability company are publicly traded, then a minimum of three members are required.[24] There is no limit set by the law for the maximum number of management board members. It is left to the discretion of the general meeting of shareholders to indicate an exact number of the management board members in the company's articles of association.

As regards the supervisory board, it must consist of at least three members. However, if the shares of the public limited liability company are publicly traded, then a minimum of five members are required.[25] The Commercial Law sets for the maximum of 20 members for the supervisory board.[26]

2.1.2 Who can be a de iure director

Only natural persons having legal capacity can be elected as members of either the management board[27] or the supervisory board[28] of a company. The Commercial Law does not provide for an option that a legal person could perform the duties of a director. The Commercial Law does not set residence requirement for the management board or supervisory board members, however some time ago this was the case. There are no maximum age restrictions as well.

[18] Commercial Law 2000, s 305 (1)
[19] Commercial Law 2000, s 210 (4)
[20] Commercial Law 2000, s 224 (2), s 296 (2) and s 305 (2)
[21] Commercial Law 2000, s 305 (3) and s 296 (1)
[22] Commercial Law 2000, s 220 (2¹) and s 224 (3)
[23] Commercial Law 2000, s 306 (1)
[24] Commercial Law 2000, s 304 (1)
[25] Commercial Law 2000, s 295 (4)
[26] Commercial Law 2000, s 295 (5)
[27] Commercial Law 2000, s 221 (3) and s 304 (2)
[28] Commercial Law 2000, s 295 (1)

Instead, the Commercial Law provides for a list of situations that are considered either as not compatible with the standard of care or independence of a director or that do not fit the two-tier board structure. In addition to the ones provided by the Commercial Law, the articles of association of a company may provide for additional obstacles.

Thus, a person may not take a position of the management board member if[29]:

- He/she is a member of the supervisory board or auditor of a particular company;
- By a court decision he/she has been deprived of the right to a certain type or to all types of a commercial activity;
- By a court decision he/she has been deprived of taking a position in boards of companies[30];
- He/she takes the position of the supervisory board member in the controlling company of a group companies.

In addition, the Commercial Law contains strict non-competition rules applicable to members of the management board.

There are no non-competition rules provided with respect to members of the supervisory board.

A person may not take a position of the supervisory board member if[31]:

- He/she is a member of the management board, an auditor, a procura holder or a holder of a commercial power of attorney of a particular company;
- He/she takes a position of the management board member in the depending company or has the rights to represent such company.

2.1.3 De facto and shadow directors

The Commercial Law does not explicitly establish separate concepts for a *de facto* director or shadow director. Instead it recognises the situation that a company may be represented by its authorised representatives having a rather wide scope of authorisation. In addition, there might also be third parties who could influence either the legal or authorised representatives of the company not to act in the best interests of the company, thus causing losses to the company.

Thus, in practice companies may introduce a role of a ‘managing director’, a ‘president’, a ‘chief executive officer’ who will be engaged in the management of company’s business activities. Such roles are not addressed by the Commercial Law but rather are governed by the contractual relations between the company and the employee. The management board member may have such a role in the company. Depending on the intensity and scope of the management board member’s involvement in the company’s day-to-day activities the contractual relations between the management board member and the company may be built on the basis of employment contract or agency contract.

[29] Commercial Law 2000, s 221 (4) and s 304 (3)
[30] This obstacle is applicable only to private limited liability companies
[31] Commercial Law 2000, s 295 (2)

In practice, management board members often delegate tasks to key employees of the company. It should be noted that the delegation does not limit or exclude the liability of the management board.

There is, however, one section in the Commercial Law that allows holding also other persons not being *de iure* directors liable for the losses caused to the company.[32] This may happen in case a person (may it be a natural or legal person or partnerships[33]) has influenced a member of the management board, a member of the supervisory board, a procura holder or a holder of a simple commercial proxy to act contrary to the interests of the company or to the interests of shareholders. The Commercial Law sets quite a high threshold therefore this clause may be applied only when the person has acted in bad faith. There is no requirement to establish that the person's intent was to cause material loss to the company, yet the causal link must exist between the action made under the influence and the losses to the company.[34]

If there is a ground for holding management board or supervisory board members liable for loses caused to the company by breaching their duty of a prudent and careful manager, the person who has used the influence will be jointly and severally liable with the members of the management board and the supervisory board.

However, there are two exceptions under the Commercial Law[35] when a person exercising the influence will not be held liable. The first is when the person has used the influence *via* voting rights at the general meeting of shareholders and the second is in case of using the decisive impact according to the Groups of Companies Law (*Koncernu likums*).[36] There are two ways the lawful decisive impact may manifest.[37] First is when the companies have entered into the agreement establishing the Group of Companies (*Koncerna līgums*) regarding either management or transfer of the profit or a combination of both. In the second way the decisive impact is established through the shareholding if, for example the dominant company has majority of votes or it solely has right to appoint majority of directors, or the shareholder controls the majority of votes in the company on basis of the agreement with other shareholders.

Chapter XI of the Commercial Law does not identify other persons who might be considered as directors and thus be held liable. However, in private limited liability companies the general meeting of shareholders is allowed to adopt also other issues at its exclusive discretion that normally would fall in the scope of responsibility of the management board or of the supervisory board.[38] This means that the general meeting of shareholders is entitled to engage in the management of the company. However, in such case the shareholders voting for a particular decision are jointly and severally liable for the loss caused as a result of this decision.[39] In case of public limited liability companies, the general meeting of shareholders is not entitled to adopt decisions pertaining to responsibilities of either the management board or of the supervisory board.

[32] Commercial Law 2000, s 168 (1)
[33] Aigars Strupišs, *Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 138 (§ 332)
[34] Aigars Strupišs, *Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 139 (§ 333.3)
[35] Commercial Law 2000, s 168 (4)
[36] Groups of Companies Law 2000 (*Koncernu likums*)
[37] Groups of Companies Law 2000, s 3
[38] Commercial Law 2000, s 210 (2)
[39] Commercial Law 2000, s 210 (2)

3 SCOPE OF DIRECTORS' DUTIES

3.1 Types of directors' duties

Management board and supervisory board members are perceived as fiduciaries of the company's shareholders by running the property that the management board members or the supervisory board members do not own. [40] A fiduciary duty of directors in a two-tier board structure manifests itself in different duties. Namely, the duties of the management board stem from a general duty to manage the company, to do the business for a return and to promote achieving the company's aims. In its turn, the supervisory board members are responsible for controlling that the management board's activities comply with the interests of the shareholders and the company is run in a lawful manner. The Supreme Court has also recognised the fiduciary nature of the management board member's duties.[41]

The Commercial Law establishes the general standard for activity of a management board and a supervisory board member. It requires that the management board and supervisory board member in fulfilment of his/her duties acts as a prudent and careful manager would do.[42] As a result, the directors face liability in case the company incurs losses that have been caused by the failure of directors to act as a prudent and careful manager would do.

Content of the prudent and careful manager's standard is uncertain. It is partly because there is no well-established case law on this matter and also, presuming that courts have the cases on directors' liability on their agenda, judgements of lower instance courts are often not publicly available. Therefore, it is hard to evaluate the court's response even to the attempts to interpret the scope of directors' duties expressed in the leading ideas in related legal systems.[43]

Nevertheless, a general standard of a prudent and careful manager can be found in the Civil Law, mainly describing the situations where the fiduciary element is recognised.[44] While the Civil Law recognises two sides of this duty (subjective understanding and objective understanding of a prudent and careful manager), there is a view[45] that in the business sphere the standard of a prudent and careful manager requires looking at what objectively can be expected from a prudent and careful manager in a business or even in a particular type of business. This view is grounded in the understanding that not only the director is liable for gross negligence but his/her liability starts already for slight/ordinary negligence which is subject to the objective understanding of a prudent and careful manager.[46] Thus the liability of directors as professionals running a business is more severe as

[40] Aigars Strupišs, *Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 143 (§342)

[41] Judgement No. SKC-805 of the Chamber of Civil cases of the Senate of the Supreme Court of the Republic of Latvia, dated 5 December 2007, available at: http://www.at.gov.lv/lv/info/archive/department1/2007/?print=1

[42] Commercial Law 2000, s 169 (1)

[43] In a case against the former management board members the company when describing the duty to avoid conflict of interests situations refered to the leading ideas in related legal systems (UK and Germany). The court pointed at the fact that the company (plaintiff) has not indicated a clear reference to the Commercial Law. Judgement in the civil case C30395508, C30-1814/16 of the Riga City Vidzeme Municipality Court, dated 30 September 2009 (not published)

[44] Liene Abramoviča, Krietna saimnieka rūpības pienākums Komerclikumā. *Jurista Vārds*, Nr. 44 (447), 7 November 2006

[45] Liene Abramoviča, Krietna saimnieka rūpības pienākums Komerclikumā. *Jurista Vārds*, Nr. 44 (447), 7 November 2006; Jānis Bērziņš, Komercsabiedrības amatpersonu civiltiesiskās atbildības aspekti. *Jurista Vārds* Nr. 19 (572) 12 May 2009

[46] Kalvis Torgāns, 1646 in Kalvis Torgāns (ed), *Civillikuma komentāri. Saistību tiesības (1401.-2400.p.)* (Mans īpašums 2000)151

compared to the general civil liability regime. It will not be enough to refer to the fact that director's care about the company's matters equals to his/her care about own property[47], what will be required instead is compliance with the perception of how objectively the director has to act.

According to the existing commentaries[48] on the Commercial Law and selected pieces of case law, the following duties arise out of the general principle of a prudent and careful manager.

3.1.1 Duty to obey law, articles of association of the company and decisions of the general meeting of shareholders

This group of duties defines the general scope for the directors' authority. Thus the directors face the general duty to follow law, the articles of association as the document regulating internal organisation of a company and the interests of shareholders expressed through the general meeting of shareholders.

This duty has been supported also by the case-law.[49]

(a) Duty to observe the law;

(b) Duty to observe the articles of association of a company; and

(c) Duty to observe decisions of the general meeting of the shareholders of the company (for the management board there will also be the duty to observe decisions of the supervisory board).

In addition, the Commercial Law lists specific duties addressed to the management board and the supervisory board. For the management board this involves convening the annual general meeting of shareholders pursuant to the procedure and at the time as provided by the Commercial Law and the articles of association. The annual general meeting of shareholders has to be called not less than once a year.[50] Apart from a duty to call the extraordinary general meetings of shareholders, there are several cases provided by the Commercial Law, when the management board must convene the extraordinary general meeting. This duty is applicable to both private and public limited liability companies and must be followed in case:

- the losses of the company exceed a half of the company's share capital, or
- the company has limited solvency or insolvency criteria are met by the company or threats of meeting such criteria exist.[51]

[47] Subjective standard relates to the concept of a gross negligence in the Civil Law. Kalvis Torgāns, 1645 in Kalvis Torgāns (ed), *Civillikuma komentāri. Saistību tiesības (1401.-2400.p.)* (Mans īpašums 2000) 150

[48] Aigars Strupišs, *Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 143 (§342), Liene Abramoviča, Krietna saimnieka rūpības pienākums Komerclikumā. *Jurista Vārds*, No. 44 (447), 7 November 2006; Jānis Bērziņš, Komercsabiedrības amatpersonu civiltiesiskās atbildības aspekti. *Jurista Vārds* No. 19 (572) 12 May 2009

[49] Decision in the civil case C04266607, C-2666/15 of the Riga Regional Court, dated 27 July 2007 (not published) is refered to by Jānis Bērziņš. In court's view failure to observe the articles of association and the information requests by the general meeting of shareholders as well as acting dishonestly has led to a conclusion that the person has not complied with the standard of a prudent and careful manager. Jānis Bērziņš, Komercsabiedrības amatpersonu civiltiesiskās atbildības aspekti. *Jurista Vārds* No. 19 (572) 12 May 2009

[50] Commercial Law 2000, s 213 (1) and s 214 for private limited liability companies and s 269 (2) and s 273 for public limited liability companies

[51] Commercial Law 2000, s 219 with respect to the private limited liability companies and s 271 to the public limited liability companies

The law also obliges the management board to provide the supervisory board at least once per quarter with a report about the company's activities and financial state. In addition, with respect to private limited liability companies the Commercial Law is straightforward by stating that the supervisory board must be notified immediately in case the company's financial state deteriorates as well as about any other important circumstances related to the business of the company.[52] As regards public limited liability companies, this last duty[53] may be considered as implied in the duty to inform about any other important circumstances in case of the business of the company.[54]

In case the company's financial state is such that the company meets the insolvency criteria established by the Insolvency Law[55], it is the duty of the management board to file an insolvency claim with the court.[56]

One more aspect of the company's management addressed by the Commercial Law is the duty of the management board members to organise the accounting of the company.[57] This involves also maintenance of all originals, copies or data of business transactions supporting documentation.

With respect to the supervisory board members the Commercial Law also sets separate duties, mainly reflecting the controlling function of the supervisory board and representative function of the supervisory board with respect to transactions between the company and the management board member or the company and the auditor. Specific controlling tasks are listed in Section 292 of the Commercial Law, while the articles of association may provide that the management board needs a prior approval of the supervisory board on deciding on certain issues. The Commercial Law gives a non-exhaustive list for issues that may be considered as important.[58]

Lastly, a management board member of a private limited liability company has a duty to notify the general meeting of shareholders on any transactions concluded between the company and a management board member or a supervisory board member, or a shareholder.[59]

3.1.2 Duty of loyalty

Another wide enough duty applicable to company directors is a duty of loyalty. This is not expressly defined in the Commercial Law but rather arises out of the general nature of the situation within which the directors act. In this case provisions of the Civil Law on authorisation are applicable, especially Section 2304, defining that the authorised person may not gain personal benefit out of this relationship. Thus, when applying this principle to directors, the duty of loyalty aims at restricting the authorisation granted to a director with a view of getting personal benefit.

[52] Commercial Law 2000, s 221 (6)
[53] I.e. duty to notify the supervisory board in case the company's financial state deteriorates
[54] Commercial Law 2000, s 311 and particularly (2)
[55] Insolvency Law 2010, s 57 and particularly (5), (6) and (9)
[56] Insolvency Law 2010, s 60 (3)
[57] Commercial Law 2000, s 301 (2)
[58] Commercial Law 2000, s 294 (1)
[59] Commercial Law 2000, s 221 (5)

The duty of loyalty is twofold. First, it is understood as an obligation to act in the best interests of the company. Second, it covers also loyalty towards the shareholders as aggregate.[60] The second aspect is understood as an implied duty because the Commercial Law does not provide a direct reference to it. Yet, it is recognised that directors owe this duty to the aggregate of shareholders because by the will of the general meeting the directors get appointed.[61]

The duty of loyalty of management board members involves also non-competition duty provided in Section 171 of the Commercial Law which aims at reducing the situations that a management board member is engaged in a competing business without explicit permission of the supervisory board.[62] Unless a prior consent of the supervisory board (or the general meeting of shareholders in case there is no supervisory board formed) is obtained, a member of the management board may not:

- be a general partner of a partnership or a shareholder of a company with supplemental liability acting in the same field of business as the particular company;
- enter into transactions in his/her own or a third party's name or benefit in the same field of business;
- be a member of a management board of any other company in the same field of business, unless both companies are a part of the same group of companies.[63]

In addition, the management board member has to avoid conflict of interests. With respect to public limited liability companies this duty is straightforward and captures also idea of self-dealing, i.e. the management board member has an obligation to disclose the conflict of interests (if any) between the company and the management board member or his/her spouse, a relative or brother-in-law (sister-in-law) before the meeting.[64] In a conflict of interests situation the management board member does not have voting rights on that issue. However, from the case law there is an example when the court did not recognise that a conflict of interest existed in a situation when the management board member concluded an agreement with a company owned by him. The court's argument was that the Commercial Law does not prohibit the management board member from entering into agreements with a related company.[65]

While this is not the duty applicable only to directors, they may not disclose the company's business secrets.[66] In case of the breach of this duty the company will be entitled to claim damages for unlawful disclosure of business secrets.

3.1.3 Duty of skill and care

Lastly, running the business involves certain risks. This is in the very essence of a company, that it is formed and run with the aim of making profit. Management board members are put in a not-so-easy situation. First, they need to comply with the fiduciary duty and manage the company in a way it

[60] Aigars Strupišs, Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti) („A.Strupiša juridiskais birojs" SIA 2003) 145 (§343.4-343.5)
[61] Aigars Strupišs, Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti) („A.Strupiša juridiskais birojs" SIA 2003) 145 (§343.5)
[62] See Chapter 2.1.1. of this report.
[63] Commercial Law 2000, s 171 (1)
[64] Commercial Law 2000, s 309 (3)
[65] Judgement in the civil case C30395508, C30-1814/16 of the Riga City Vidzeme Municipality Court, dated 30 September 2009 (not published)
[66] Commercial Law 2000, s 19

makes profit, and second, they must preserve the company's assets.[67] Therefore it is the duty to employ an adequate level of skill[68] and care excluding even ordinary negligence, which does not prohibit undertaking of certain risk, provided that such risk can be considered as reasonable in the given market circumstances. There are other duties of the management board member which are identified in the legal theory that in the essence resemble the duty of adequate level of skill and care. They require a management board member not to delay the decision-making, to make well-informed decisions with an aim to reduce possible risks.[69] Another aspect of skill and care would be the duty to act independently, yet the management board member still has to take into account the legitimate interests of other management board members as well as the supervisory board members.[70]

3.1.4 Relationship between the different duties

Under the general standard of a prudent and careful manager even ordinary/slight negligence is not tolerated. Therefore, it can be said that the duties are cumulative. Breach of a duty, even if it does not cause losses to the company, may lead to the breach of loyalty. For example, management board members of a public limited liability company may be revoked prematurely only for important cause. As an example for such an important cause the loss of the trust is mentioned.[71] Thus, breach of duties by a director may lead to the loss of the trust from the shareholders' side.

In practice, however there might be conflicts between different duties. For example, when there is a conflict between a duty to observe the law and a duty to follow the directions of the general meeting of shareholders the first should prevail. Compliance with the unlawful decision of the general meeting of shareholders will not save a director from the liability for beaching the law or articles of association.

3.1.5 Where are directors' duties regulated?

The Commercial Law does not provide a complete list of duties for company directors, it rather provides for a general division between the managerial and representative function of the management board and controlling function of the supervisory board. These main functions stem from the law and it has been mentioned[72] that from these functions one can arrive to the conclusion about the authority of the directors as grounded rather in law as the will of the shareholders. In addition to the main functions, there are still broad groups of duties and expected standard of performance introduced by the Commercial Law.

The expected standard of directors' performance is provided by Section 169 part one of the Commercial Law. In addition, the Commercial Law specifies separate duties for the management

[67] Aigars Strupišs, *Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 147 (§345)
[68] It was suggested by the Principles of Corporate Governance and Recommendations on their Implementation of the Exchange NASDAQ OMX Riga that when forming the management board it is important to ensure that each of the management board members has suitable education and work experience http://www.nasdaqomxbaltic.com/files/riga/corp_gov_May_2010_final_EN.pdf , acessed on 15 February 2012
[69] Liene Abramoviča, Krietna saimnieka rūpības nozīme Komerclikumā. *Jurista Vārds*, No. 44 (447), 7 November 2006
[70] Judgement No. SKC-0673-07 of the Senate of the Supreme Court of the Republic of Latvia, dated 12 December 2007, available at: http://juridika.tiesas.lv/template/index.php?type=3&id=518&cat=1 , accessed on 5 March 2012
[71] Commercial Law 2000, s 306 (2)
[72] Jānis Kārkliņš, Par valdes locekļa tiesisko statusu. *Jurista Vārds*, Nr.9 (708), 28 February 2012

board[73] and supervisory board members[74]. To summarise, directors must obey law, the articles of association and decisions of the general meetings of shareholders.

In the light of this, it is possible to arrive at a more precise list of duties when looking at the legislation regulating a particular field of business or a certain aspect of the business (employment relations, tax law, consumer protection etc.).

3.2 To whom are the director's duties owed to?

Primarily, directors' duties are owed to the company. Section 169 of the Commercial Law defines the director's liability towards the company only. When describing the underlying understanding of the company the commentators tend to emphasise "shareholder primacy" and interests of the shareholder body as a whole in describing the interest of the company.[75] At the same time shareholders are considered only as holders of an economical interest in the company and not the "owners" of the company (or its assets). The liability towards other stakeholders may be invoked under the Civil Law. Namely, the principles of the tort law will be applicable.

3.3 The director as a shareholder

A company director must act in the best interests of the company. Moreover, an objective standard of a prudent and careful manager will apply to the company director. The general meeting of shareholders of a private limited liability company has been granted a wider discretion under the Commercial Law than a public limited liability company. Thus the general meeting of shareholders may decide on the issues pertaining to responsibilities and powers of either a management board or a supervisory board. For example, the general meeting of shareholders of a private limited liability company could, irrespective to the fact that it is the responsibility/discretion of a management board, decide on entering in a transaction. Then, if the transaction causes losses to the company, the shareholders voting for respective decision could be held liable. The liability of shareholders voting for the decision would be joint and several.[76]

It must be noted that the Commercial Law does not allow the general meeting of a public limited company to intervene in the managerial discretion as freely as it is in case of a private limited liability company.

3.4 Time span of the duties

The general principle is that duties apply to the persons during the directorship. Duties of a director begin as of election of a director and so the liability. Duties of the director end either with expiry of the term of office, i.e. for public limited liability companies it will be five years unless the articles of

[73] Commercial Law 2000, s 221 (5) - (6) with respect to private limited liability companies and s 221 (5) - (6) to the public limited liability companies
[74] Commercial Law 2000, s 292
[75] Aigars Strupišs, *Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 28 (§31)
[76] Commercial Law 2000, s 210 (2)

association provide for a shorter term. For private limited liability companies there might even not be a time limit applicable unless the articles of association provide an exact term. Alternatively, duties may also end with a revocation of the director form his/her position or a director is entitled to resign from director's position at any time. The obligation not to disclose company's business secrets will apply continue to apply after the person leaves the director's position.

Yet, the liability does not end with expiry of duties as the former management board members may be held liable for the losses caused to the company during their directorship. This aspect of the directors' liability, in particular with respect to the management board members, was supported by the case law.[77]

3.5 Application of duties to directors

To sum up, the Commercial Law establishes a special liability regime only for *de iure* directors of limited liability companies. The Commercial Law addresses the liability of the *de iure* directors and not the management board or the supervisory board as collective bodies. At the same time, under the Commercial Law the liability of the members of the management board and the supervisory board is joint and several.[78] Thus, it is possible to claim the entire amount of losses from each of the management board or the supervisory board members individually. Besides, the liability of the management board and supervisory board members under the Commercial Law will be towards the company.

Liability of authorised representatives will be governed by the Civil Law.

Company Law provides for special arrangements for directors in companies which belong to a group of companies. However, it must be noted that currently the application of this law is not very popular. At the same time, there are plans for incorporation of the Group of Companies regulation in the Commercial Law, thus making the application more straightforward.

[77] Judgement No. SKC-747/2006 of the Department of Civil cases of the Senate of the Supreme Court of the Republic of Latvia, dated 20 December 2006, available at: http://www.at.gov.lv/info/archive/department1/2006/

[78] Commercial Law 2000, s 169 (2)

4 LIABILITY FOR BREACH OF DUTY

4.1 Breach of a standard of a prudent and careful manager

Section 169 of the Commercial Law provides a framework for directors' duties and liability towards the company and exemption from the liability. Section 169 part two establishes the basis of a civil liability applicable to both management board and supervisory board members for the losses caused to the company they represent. Yet, the difference in practice is made by looking at the functions and duties of the management board and supervisory board. The management board members must manage the company as a body; same is for the supervisory board members as they must work as a body to supervise the company's management. Therefore the liability of directors is joint and several,[79] moreover the liability applies both ways – horizontally and vertically (liability of the management board members may also trigger the liability of the supervisory board members). Nevertheless, the difference in practice is made by looking at the function and duties breached. As discussed in the previous section, when performing their duties directors must comply with the general standard of a prudent and careful manager,[80] avoiding even slight/ordinary negligence. What it means to be a prudent and careful manager in a particular situation will be evaluated on a case-by-case basis.

In addition, the Commercial Law establishes a presumption of guilt on the part of directors.[81] In that sense the regulation of the directors' liability under the Commercial Law differs from the general regulation of liability under the Civil Law which requires the claimant to prove the guilt of the director.[82]

In addition to the liability towards the company, company directors may be held liable for damage caused by an unlawful act to a third party.[83]

Moreover, a breach of the director's duties is also addressed by the Latvian Administrative Violations Code and the Criminal Law.

4.1.1 Conditions for liability under Section 169 of the Commercial Law

There are three conditions needed to invoke director's liability under Section 169 part two of the Commercial Law: loss, action or inactivity by the director and a causal relationship between the first two elements. This means that if a breach of the duty by a director leads to losses to the company, the company will be entitled to claim these losses from the director. The Civil Law provides that both direct and indirect losses must be compensated.[84]

Thus the claimant must establish with a sufficient level of certainty all three conditions:

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[79] Commercial Law 2000, s 169 (2)
[80] Commercial Law 2000, s 169 (1)
[81] Commercial Law 2000, s 169 (3)
[82] Judgement No. SKC-25/2012 of the Department of Civil cases of the Senate of the Supreme Court of the Republic of Latvia, dated 25 January 2012, available at: http://www.at.gov.lv/lv/info/archive/department1/2012/
[83] Civil Law 1937, s 1635-1650
[84] Kalvis Torgāns, 1775 in Kalvis Torgāns (ed), *Civillikuma komentāri. Saistību tiesības (1401.-2400.p.)* (Mans īpašums 2000) 270

(b) Loss

The company must have suffered the loss (damages). The Civil Law defines the loss as each material reduction (including lost profit)[85] that is possible to express in the terms of money. There is a view that in case it would be possible to prove that the loss resulted from the loss of reputation, then it might be possible to claim also the lost profit as a loss incurred.[86]

(c) Act of director

There must be either a director's action or failure to act that has led to the losses to the company.[87] For example, a failure to submit required information on time to a tax authority or submission of false information or violation to withhold taxes lead to calculation of late payment to the company. For example, the company may incur a monetary fine for violation of employment related enactments. The company may incur loss for entering into an agreement on obviously disadvantageous terms and conditions, for example exorbitant termination clause.[88] The management board member may be held liable for the loss caused to the company if in the decision-making for a particular issue the management board member has not disclosed the fact of the conflict of interests.[89]

(d) Loss causation

The third condition to prove is the causal relationship between the loss incurred by the company and the action or failure to act of a director. For example a court of the first instance rejected a claim against the former management board members for concluding a lease agreement on behalf of the company and the lessor, a company represented and owned by the same directors, basically the so-called self-dealing. The company represented by a new management board member incurred direct loss from premature termination of the lease in order to avoid future loss. One of the arguments for the court was that it was not possible to establish a causal relationship between the loss (contractual penalty for premature termination) and the act of the former directors.[90]

4.1.2 Burden of proof

The claimant must establish with a sufficient level of certainty all three conditions for directors' liability, i.e. particular action (or the failure to act) of directors, exact amount of losses suffered by the company and the causal relationship between the actions of the director and losses caused to the company.

Directors (each individually) will have to prove that he/she has acted as a prudent and careful manager would do, in case he/she wants to use the exemption provided in Section 169 part three of the Commercial Law.

[85] Kalvis Torgāns, 1770 in Kalvis Torgāns (ed), *Civillikuma komentāri. Saistību tiesības (1401.-2400.p.)* (Mans īpašums 2000) 267

[86] Aigars Strupišs, *Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 147 (§346.1)

[87] This corressponds to the concept of direct loss, while the Civil Law allows to claim also indirect losses. Kalvis Torgāns, 1773 in Kalvis Torgāns (ed), *Civillikuma komentāri. Saistību tiesības (1401.-2400.p.)* (Mans īpašums 2000) 269

[88] Judgement in the civil case C30395508, C30-1814/16 of the Riga City Vidzeme Municipality Court, dated 30 September 2009 (not published)

[89] Commercial Law 2000, s 309 (3)

[90] Judgement in the civil case C30395508, C30-1814/16 of the Riga City Vidzeme Municipality Court, dated 30 September 2009 (not published)

4.2 Breach of the non-competition duty

The non-competition duty[91] is applicable to management board members and is considered as one aspect of a broader duty of loyalty. Basically, the management board member breaches the duty in case he/she, without a prior consent of a supervisory board:

- becomes either a general member or a shareholder with a supplemental liability of a business entity operating in the same field as the company; or
- enters into transactions in his/her own or a third party's name or benefit in the same field of business (this covers situations when the management board member acts as an individual merchant, a member of a partnership with representation rights, a management board member of a limited liability company, a holder of procura or a simple commercial proxy of a limited liability company, or an entrepreneur as well as to act for the benefit of other person on the basis of a proxy); or
- takes a position of a management board member in the same field of business (if that company is not a part of the same group of companies).

In case of the breach of a non-competition duty there are two possible (alternative) remedies available for a company.[92] The company may claim compensation for losses (there must be a causal relationship between the losses and the breach of the non-competition duty), or alternatively the company may claim that the transaction entered into by the particular management board member is considered as concluded by the company. In the latter case the company is entitled to the net profit received or to the transfer of the rights of claim to the company.[93]

4.3 Exemptions and limitations

The Commercial Law does not provide for an option to exclude the director's liability in the articles of association. However there are a number of exemptions from the liability under the Commercial Law.

(e) Proving compliance with the standard of a prudent and careful manager

Section 169 part three of the Commercial Law establishes a presumption of guilt on the part of directors. Directors may escape liability in the event they prove that their acts correspond to a standard of a prudent and careful manager. Thus the directors will be the ones required to prove compliance of their acts with the general standard of a prudent and careful manager. Moreover, because of the concept of guilt, the directors will have to prove compliance with the standard of a prudent and careful manager each individually.[94]

The fact that the management board member had voted against particular decision may not be sufficient ground for applying this exemption. It has been mentioned that additional facts must be taken into account. For instance, has the management board member participated in the execution of

[91] Commercial Law 2000, s 171
[92] Commercial Law 2000, s 171 (2)
[93] Commercial Law 2000, s 171 (2)
[94] Aigars Strupišs, *Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 149 (§350)

the decision or has he notified the supervisory board or the general meeting of shareholders or has he resigned from the position of a director.[95] Thus consistency of all related actions of the management board member will be taken into account.

(f) Acting bona fide according to a lawful decision of the general meeting of shareholders

Directors will not be held liable for the losses caused to the company if they have acted *bona fide* according to a lawful decision of the general meeting of shareholders.[96] Since in certain cases provided by the Commercial Law the general meeting of shareholders represents and expresses the interests of the company, it is also entitled to adopt such decisions.

To exercise this exemption, the decision of the general meeting of shareholders has to be adopted within the responsibilities and powers of a general meeting of shareholders and in accordance with the law and the articles of association.[97]

A supervisory board's approval to an action of the management board causing loss to the company will not allow using this exemption.[98] Instead, this may serve as a proof that the supervisory board has breached its duty to act as a prudent and careful manager in supervising the management board's activity.

(g) Release from the liability

The general meeting of shareholders has discretion (both discretion about whom to release and in what extent[99]) to release the directors from the liability. Alternatively the general meeting of shareholders may also decide on a settlement with the directors.[100] This is *ex-post* mechanism for release from the liability. It requires disclosure to the general meeting of shareholders of the information about particular act that has caused losses to the company. Thus decision about release of directors from the liability in general (which can be observed in practice) will be invalid. In addition, the decision of the general meeting of shareholders on approval of the annual report *per se* does not release the directors from the liability for the action during the reporting year.[101]

Only the general meeting of shareholders will be entitled to decide on release from the liability. However, release of directors from the liability by the general meeting of shareholders does not limit the minority shareholders from the right to initiate a claim in the name of the company against the directors.[102]

[95] Aigars Strupišs, *Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 150 (§352)
[96] Commercial Law 2000, s 169 (4)
[97] Aigars Strupišs, *Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 151 (§355)
[98] Commercial Law 2000, s 169 (4)
[99] Aigars Strupišs, *Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 174 (§414)
[100] Commercial Law 2000, s 173 (1)
[101] Commercial Law 2000, s 173 (3)
[102] Commercial Law 2000, s 173 (2)

(h) Other ways to limit/cap liability

Directors of a private limited liability company may limit their *ex-ante* liability by asking the general meeting of shareholders to decide on a particular decision.[103] The Commercial Law does not provide for such a strategy for limiting the director's liability in public limited liability companies.

It is of course possible to introduce detailed decision-making procedures and to record properly the adopted decisions in the meeting minutes. Another strategy would be dividing the areas of responsibility among the directors and describing this for example in the management agreements concluded between the company and its directors. It is also possible to provide for a list of material decisions in the company's articles of association for adoption of which the management board needs a prior approval from the supervisory board.[104] However, this does not exclude the liability *per se.*

4.4 Insurance against liability

Another way to limit the civil liability of directors is to insure director's liability. D&O liability insurance is a special type of third party liability insurance. Although, insurance companies operating in Latvia provide such service, it is not widely used. One of the reasons of course is the cost the company will have to bear. Since the liability of the directors is joint and several, the insurance must cover the liability of all directors. The insured amount varies from EUR 3,000,000 to 10,000,000.[105] It must be noted that it is not a mandatory requirement to obtain D&O liability insurance.

4.5 Consequences of liability

The consequences of liability of directors are compensation for the loss to the company.

Director's liability does not expire with a resignation of a director; however resignation may mitigate the liability in certain cases (see 4.1.2. (a) above). According to the case law it is possible to initiate a claim for the losses caused to the company also against the former management board members.[106]

[103] Commercial Law 2000, s 210 (2)
[104] Commercial Law 2000, s 294
[105] Description of D&O insurance practice by MARSH, available at: http://www.marsh.lv/aktuali/documents/DandOprakseMarsh.pdf, accessed on: 5 March 2012
[106] Judgement No. SKC-747/2006 of the Department of Civil cases of the Senate of the Supreme Court of the Republic of Latvia, dated 20 December 2006, available at: http://www.at.gov.lv/info/archive/department1/2006/

5 DUTIES IN THE VICINITY OF INSOLVENCY

Duties in the vicinity of insolvency are addressed both by the Commercial Law and the Insolvency Law, while breach of the directors' duties in the vicinity of insolvency may lead also to criminal liability of the management board members, for example for driving the company into insolvency.

The Insolvency Law introduces two main corporate insolvency procedures:[107]

- legal protection proceedings which by combination of various methods (for example, debt capitalisation, reorganisation, postponing the maturity date of the debts, alienation or encumbrance of assets or other methods which are in line with the general aim of the legal protection proceedings)[108] aim at restoring the company's solvency;
- insolvency proceedings aim at satisfaction of the creditors' claims from the assets of the debtor.

It must be noted that during the legal protection proceedings the company is still managed by directors. However, there are a number of restrictions imposed on the managerial discretion with the overall aim not to deteriorate the financial state of the company and not to harm the creditors as an aggregate.[109] In its turn, during the insolvency proceedings the management and control over the company and its assets is given to the insolvency administrator.

5.1 What does 'vicinity of insolvency' mean?

The triggering factor of the insolvency with respect to the company has changed. While the previous regulation of insolvency proceedings provided for a combination of both the balance-sheet test and cash-flow test, the Insolvency Law which came into force in 1 November 2010 applies the cash-flow test only.[110] Therefore, the main criteria in fact will be the company's ability to pay its debts when they come due, i.e. the company's solvency.

There is also no time gap caused by the division between onset of insolvency and initiation of insolvency proceedings. The current Insolvency Law provides that a company is considered to be insolvent as of the moment the court adopts a respective decision.[111] Thus the court's decision on establishing company's insolvency is also the triggering moment to company's creditors because allowed enforcement mechanisms shift from individual procedures to collective procedures. However this line is not as clear with respect to the company's directors.

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[107] Council Regulation (EC) 1346/2000 on insolvency proceedings [2000] OJ L160/14, Annex A
[108] Insolvency Law 2010, s 38 (1)
[109] Insolvency Law 2010, s 49 (1)
[110] A cash-flow test is applied when a creditor submits an insolvency claim against the debtor as well as in situation when the company itself files the insolvency claim. Helmuts Jauja, Piezīmes pie jaunā Maksātnespējas likuma. *Jurista Vārds* Nr. 8 (655) 22 February 2011
[111] Insolvency Law 2010, s 4 (2)

5.2 Change of existing duties

Vicinity of insolvency does affect directors' duties. While directors still owe the duties to the company, the Commercial Law imposes an explicit duty on the directors towards the shareholders. Namely, directors are obliged to convene the general meeting of shareholders in case the losses of the company exceed a half of the company's share capital, or the company has limited solvency or insolvency criteria are met by the company or threats of meeting such criteria exist.[112] Consequently, the general meeting of shareholders has to decide on further actions. For public limited liability companies the Commercial Law provides possible alternatives starting from filing an insolvency claim or application for legal protection proceedings, liquidation of the company or share capital increase, reorganisation or other activities with an aim to improve the company's financial standing.[113]

With respect to the creditors, the Insolvency Law does not grant a straightforward right to a creditor to file an insolvency claim against the company. Instead the creditor must warn the nonperforming debtor first and only in case the debtor has not either paid the debt or raised well-grounded objections within three weeks as of submission of the warning the creditor may file the insolvency claim at the court. However, as mentioned in Chapter 3.2., when the company's financial state is such that the company meets the insolvency criteria established by the Insolvency Law, particularly when the company is not able to satisfy its debt obligations when they come due,[114] it is the duty of the management board to file an insolvency claim at the court. This is the moment when directors must take into account other stakeholders. However, stakeholders' interests can be identified already before initiation of insolvency through the ex-post mechanism of the Insolvency Law on transaction challenging.

One of the basic principles of the Insolvency Law states that *"the creditor and debtor may not perform individual actions that would harm the interests of the creditors as an aggregate"*.[115] In addition the rights must be exercised *bona fide* and without an aim of self-enrichment.[116] Thus, it can be said, that with insolvency as a collective procedure the creditors (for example, suppliers, employees) as an aggregate become the residual owners of the company.

5.3 Newly arising duties

Since directors control the company's information and are more aware of its financial situation they owe the duties to the creditors as an aggregate already some time before the company is recognised insolvent by the court. This can be seen as a sort of policy issue where the stakeholders' perspective is brought in the concept of directors' duties. It is possible because the Insolvency Law introduces the period of time before the initiation of insolvency where certain transactions can be challenged in the name of collective interest of creditors.

Thus, the administrator can challenge any transaction causing losses to the company as void, if a particular transaction is concluded:[117]

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[112] Commercial Law 2000, s 219 with respect to the private limited liability companies and s 271 to the public limited liability companies
[113] Commercial Law 2000, s 271
[114] Insolvecy Law 2010, s 57 (5)
[115] Insolvency Law 2010, s 6 (3)
[116] Insolvency Law 2010, s 6 (8)
[117] Insolvecy Law 2010, s 96 (1)

- Up to three months before initiation of insolvency proceedings irrespective to the fact whether the contracting party or the person for whose benefit the transaction was concluded knew about the losses caused to the creditors, or
- Up to three years before initiation of insolvency and the contracting party or the person for whose benefit the transaction was concluded knew or ought to have known about causing losses. If the transaction causing losses to the company is concluded with an 'interested party' of the company or for the benefit of such interested party, then it is presumed that these persons knew about losses. Thus the burden of proof that they have acted *bona fide* lies on them.[118]

The 'interested party' concept has a retroactive force for up to five years from the initiation of the insolvency and it covers:

- Shareholders, directors, holders of procura or commercial power of attorney;
- Spouse, relative or brother-in-law/ sister-in-law (up to the second level) of the company's founder, shareholder or director; or
- Creditor being in the same group with the company.

Thus, the 'twilight zone' before the initiation of insolvency can trigger the directors' liability particularly through their insider knowledge, namely that the directors knew about the company's financial state and still continued trading or continued trading at the expense of other/exiting creditors. In addition to the transactions that can be recognised as void, also the so-called 'transactions undervalue' (gifts) can be challenged up to six months back from the insolvency initiation date.[119] Also transactions of preference of one creditor at the expense of others in certain cases can be challenged.[120]

All the above mentioned transactions are evaluated and challenged by the insolvency administrator. Among other duties, the insolvency administrator must evaluate and initiate claims against company's directors and shareholders for the compensation of losses caused to the company.[121]

[118] Insolvency Law 2010, s 96 (2)
[119] Insolvency Law 2010, s 97
[120] Insolvency Law 2010, s 99
[121] Insolvency Law 2010, s 65 (8)

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue?

6.1.1 The company as plaintiff

Directors are liable in front of the company for the losses caused to it. This means that the company has standing to sue and therefore the claim for compensation of losses against directors is brought by the company.

Section 172 of the Commercial Law provides a framework for the company to initiate claims against the founders, directors, or auditor of the company.[122] In addition, this enforcement mechanism implies also a right to bring a claim also against the persons mentioned in Section 168 (i.e. a person who has exercised the influence over directors, a procura holder or a holder of a simple commercial proxy in bad faith as a result of which the company has suffered loss).[123]

In order to initiate a claim against directors for losses caused to the company the following conditions must be present[124]:

- Losses caused to the company as a result of the action (or failure to act) of a director;
- No exclusion from liability exists, meaning:
    1) Directors have not proven compliance of the action with the standard of a prudent and careful manager;
    2) The general meeting of shareholders has not released directors from a liability for the losses caused to the company; or
    3) Directors have not fulfilled their obligations under the agreement on amicable settlement;
- There is a valid decision of the general meeting of shareholders on initiating the claim against the directors. However, in certain cases also the minority shareholders may come up with a request to sue directors.

Generally the management board is the body that represents the company in relation to the claims against the supervisory board members.[125] As regards claims against management board members, the Commercial Law grants special representation rights to the supervisory board. In case there is no supervisory board formed (this can be the case only for private limited liability companies), the general meeting of shareholders may appoint a representative for the purpose of initiating and maintaining a claim against the management board members.[126]

[122] Commercial Law 2000, s 172 (1)
[123] Please refer to Chapter [2.1.2] of this report
[124] Please refer to Chapter [4.1.1] of this report regarding conditions for claiming losses from the directors and exemptions from liability.
[125] Unless the general meeting of shareholders has authorised other person to represent the company in relation to any of these claims. Commercial Law 2000, s 172 (4)
[126] Commercial law 2000, s 172 (3)

There is no special time bar for initiating the claims against directors, therefore the general time bar of the Civil Law might be applicable. The exceptions are the breach of non-competition duty and the losses caused to the company during reorganisation[127] where the time bar will be only five years as of the breach.[128] The claims must be initiated within three months as of the decision of the general meeting of shareholders or the receipt of the demand from the minority shareholders.[129]

6.1.2 The shareholders as plaintiffs

The Commercial Law grants the right to the shareholders acting through the general meeting of shareholders to come up with an initiative about bringing a claim against the shareholders in the name of the company. However, theoretically a shareholder may bring a claim against a director also according to the Civil Law. In such case, the shareholder will have to prove the exact amount of loss, particular action (or failure to act) that caused losses, causal relationship between director's action and the losses and in certain cases also guilt of a director thereof. Nevertheless, the rationale of such a claim can be questioned both in terms of the proof of the exact amount of loss suffered directly by the particular shareholder and not the company and secondly the liability regime of directors under the Commercial Law does not require the shareholder to prove the guilt of the director.

(i) General meeting of shareholders

The general principle is that only the general meeting of shareholders of the company has discretion on initiating a claim against directors in the name of the company. According to the Commercial Law this issue pertains to the exclusive scope of powers and responsibilities of the general meeting of shareholders.[130] This means that no other governing body of the company is entitled to adopt a decision on this issue.

The decision is adopted by a simple majority of the votes present at the general meeting of shareholders. The Commercial Law explicitly forbids setting higher requirements for the votes needed to adopt this decision.[131]

(j) Minority shareholders

The Commercial Law grants also the rights to minority shareholders to come up with a demand to sue directors. However, this right is not granted to each and any shareholder of the company. Minority shareholders representing in total at least 1/20 of the company's share capital or shareholding of at least LVL 50,000 (approximately EUR 71,144) may demand bringing a claim by the company against the directors.[132] This grants shareholders an alternative right from the general meeting of shareholders to demand suing directors in the name of the company. Such right exists even in case the general

[127] Commercial Law 2000, s 352 (2)
[128] Commercial law 2000, s 171 (3). In case of the breach of the non-competition duty the claims may be brought within three month time as of the moment other management board members or the supervisory board found out about the breach but not later than five years as of the breach.
[129] Commercial Law 2000, s 172 (6)
[130] Commercial Law 2000, s 210 (7) and s 268 (4)
[131] Commercial Law 2000, s 172 (1)
[132] Commercial Law 2000, s 172 (2)

meeting of shareholders with the majority of votes has rejected the decision on suing directors.[133]

(k) In the name of the company "derivative actions"

In addition to the general rights granted by the Commercial Law to the minority shareholders through the initiative to demand the company suing its directors**,** the Commercial Law provides also for a mechanism in case the responsible governing body (either the management board or the supervisory board) has not initiated the claim against the directors within a one month term as of submission of a respective demand. Thus minority shareholders representing in total at least 1/20 of the company's share capital or shareholding of at least LVL 50,000 (approximately EUR 71,144) are granted discretionary right to sue directors in the name of the company.[134] Thus they can bring a claim independently, however the claim still has to be brought in the name of the company.

6.2 Criminal and administrative sanction

The criminal liability is of course the utmost severe consequence of the violation and is applied only in most serious cases or if the offence has been repeated usually within one year, whereas not so grave violations of the law usually lead to administrative fines.

6.2.1 Administrative liability

Normally a company may incur administrative liability under the Administrative Violations Code and thus might be subject to the administrative fine. The administrative fine may cause losses to the company and this might be a reason for the company to initiate a claim for compensation of losses against directors. However, in addition to the administrative fine imposed on the company, in certain cases an administrative fine can be imposed also to the company's management board members as they are recognised as company's 'officials' under the Administrative Violations Code (*Administratīvo pārkāpumu kodekss*)[135]. Yet, it has been noted that the application of the concept of 'official' under the Administrative Violations Code to the company's management board members has been problematic.[136]

6.2.2 Criminal liability

The directors, particularly the management board members, may be held liable according to the criminal law on different grounds. For example, criminal liability may be incurred regarding:

- Driving the company into insolvency;[137]

[133] Aigars Strupišs, *Komerclikuma komentāri. III B daļa Komersanti. XI sadaļa. Kapitālsabiedrības (134.-184. panti)* ("A.Strupiša juridiskais birojs" SIA 2003) 164 (§384)
[134] Commercial Law 2000, s 172 (2)
[135] Administrative Violations Code 1984, (*Administratīvo pārkāpumu kodekss*)
[136] Edvīns Danovskis, Andra Rektiņa-Hitrova, *Valdes locekļu administratīvā atbildība*, available at: http://www.rln.lv/en/publications/2010-01-13_Saldo_ARH-ED_Valdes%20loceklu%20admin%20atbildiba.pdf , accessed on 5 March 2012
[137] Criminal Law 1998, s 213. In addition there may be also other grounds related to company's insolvency (s 214, 215 and 215¹)

- Tax-issues; for avoidance of tax payments or for hiding or reduction of income or profit or other tax applicable objects[138] or for failure to submit tax declarations after receipt of warning or for false information in the declaration[139];
- Products labelling and quality in case the trader sells such goods or provides such services to a customer that do not correspond to the established quality requirements[140] or regarding failure to observe safety requirements for the provided goods or services[141], and this caused material harm to the consumer's health, property or to the environment;
- Violation of employment limitations or regulations;[142]
- Use and exceeding authority (assigned powers) in bad faith if these acts have caused substantial harm to rights and interests of the company or to other person's rights and interests protected by law;[143]
- Fulfilment of duties neglectfully, thus causing substantial harm to the company or another person's rights and interests protected by law.[144]
- Misappropriation; unlawful acquiring of property of another person if such has been committed by a person to whom such property has been entrusted or in whose charge it has been placed.[145]

This is of course not an exhaustive list of acts triggering the criminal liability. The criminal liability and possible criminal penalty is the state's attitude towards certain illegal activities performed by an individual. Criminal conviction (if any) of a person does not bring direct profit to the company.

The Criminal Law introduces a limitation of rights as one type of sanctions that manifests itself through deprivation of right to certain or to all types of a commercial activity or on taking directors' position.[146] This sanction has a direct impact on directors, as it has been one of the obstacles listed in the Commercial Law for taking the management board member's position.

6.3 Special rights of company's creditors

In addition, the Commercial Law recognises a situation when a creditor may bring a claim against directors in its own name but for the benefit of the company. Namely, when a creditor cannot obtain satisfaction of his claim from the company, this creditor may bring a claim against directors (and also third parties as mentioned in Section 168 of the Commercial Law)[147] if the directors have caused losses to the company and have not compensated them.[148] The creditor has a burden to prove that it was not possible to obtain satisfaction of his claim from the company.

A creditor has the right to initiate the claim also if the company has waived the claim against directors or has concluded a settlement with a director, or in case the management board member has caused

[138] Criminal Law 1998, s 218
[139] Criminal Law 1998, s 219
[140] Criminal Law 1998, s 202
[141] Criminal Law 1998, s 203
[142] Criminal Law 1998, s 280
[143] Criminal Law 1998, s 196
[144] Criminal Law 1998, s 197
[145] Criminal Law 1998, s 179
[146] Criminal Law 1998, s 44 (1)
[147] A person who has exercised the influence over directors, procura holder or a holder of a simple commercial proxy in bad faith as a result of which the company has suffered loss.
[148] Commercial Law 2000, s 170 (1)

the losses when fulfilling the decision of the general meeting of shareholders or the supervisory board.[149] It must be noted that the Commercial Law provides such right for the benefit of the company, i.e. all the compensation awarded by the court would be for the benefit of the company.

The creditor may bring such a claim within the period of five years as of the day when the respective rights of claim arose.[150]

[149] Commercial Law 2000, s 170 (2)
[150] Commercial Law 2000, s 130 (3)

7 CONFLICT OF LAWS

7.1 Classification under Latvia's private international law

7.1.1 Company law

The problem of classification under private international law has been recognised as a challenging issue by the courts.[151] The Latvian approach to conflict of laws is not explicitly clear with respect to whether foreign law should be treated as a fact or as a law; however, the legal theory leans towards the notion of foreign law as a law.[152] It has been mentioned that in many cases the parties themselves prove the applicability of the foreign law by providing explanations and the other party is always free to object by providing sound counter arguments. Notwithstanding the fact that also the court has a general duty to specify the applicable foreign law, the consequences if the content of the applicable law has not been specified correctly must be evaluated.[153]

Latvia follows the real seat theory when deciding on applicable law to legal entities. The Civil Law sets a place where the legal entity's management is located as a decisive factor[154], while the Commercial Law specifies that the management board is located at the company's registered address,[155] i.e. the company must be accessible at its registered address.

Thus the Commercial Law sets a presumption that the registered address in fact is the place from which the company is effectively managed. A company is recognised as a legal entity from the moment it is entered in the Commercial Register and for the purposes of incorporation the registered address as a third party protection mechanism must be notified to the Commercial Register.

Thus the Commercial Law addresses conditions that must be fulfilled to do business in Latvia and inter alia to effectively incorporate a company in Latvia. In addition the Commercial Law implies a framework also for foreign companies who want to do business in Latvia. Thus, foreign companies may do the business either through establishing a subsidiary in Latvia or by opening a branch of a foreign company or alternatively, the companies may also operate through a permanent establishment. A subsidiary and branch of a foreign company requires registration at the Commercial Register. While the branch is not considered as a legal entity[156], registration at the Commercial Register is required.[157] It serves as a disclosure mechanism introduced as a result of implementation of the 11th Company Law Directive (89/666/EEC). If the foreign company is intending to carry out its business activities in Latvia directly in its own name without entering a branch in the Commercial Register, then this form of existence would be considered a permanent establishment in Latvia. In such case the foreign company has to register at the Latvian State Revenue Service. For tax payment

[151] Judgement No. SKC-131/2011 of the Department of Civil cases of the Senate of the Supreme Court of the Republic of Latvia, dated 27 April 2011, available at: http://www.at.gov.lv/files/archive/department1/2011/skc-131.pdf
[152] Jūlija Kolomijceva, Ārvalstu likuma piemērošana civilprocesā. Jurista Vārds Nr. 51 (646) 21 December 2010
[153] Jūlija Kolomijceva, Ārvalstu likuma piemērošana civilprocesā. Jurista Vārds Nr. 51 (646) 21 December 2010
[154] Civil Law 1937, s 8
[155] Commercial Law 2000, s 139 (1)
[156] Commercial Law 2000, s 22
[157] Commercial Law 2000, s 25

purposes, the permanent establishment is quite similar to a branch; however, it would not have separate corporate requisites.

7.1.2 Tort law

As regards the law applicable to unlawful acts committed by the company's directors to the third parties, this will be governed by the law of the country in which the damage occurs.[158] This corresponds to the general principle of Regulation (EC) No 864/2007 (Rome II).[159]

7.1.3 Special duties in the vicinity of insolvency

Cross-border insolvency proceedings will be governed by Insolvency Regulation No. 1346/2000[160], and particularly the concept of the centre of the main interests (COMI).[161] Unless otherwise proved, it is presumed that COMI corresponds to the place where the company has its registered address. Thus for companies registered in Latvia the COMI will be presumed in Latvia unless for example a substantial part of business is located in another Member State and that would be a reason for recognising that the COMI does not correspond to the place of company's registered address. If the COMI of a foreign company is in Latvia, the Insolvency Law will be applied and provisions of the Insolvency Law with respect to voidable transactions can be invoked by the insolvency administrator. However, in a cross-border situation this can be avoided under Article 13 of Insolvency Regulation No. 1346/2000.

7.2 Application of the relevant private international law rule

The Commercial Law is applicable to companies whose registered address (place from where its management is presumed to be carried out) is in Latvia. Thus director's duties arising from the Commercial Law will govern companies registered at the Commercial Register, i.e. registered in Latvia. Latvian law will also cover the issues arising from the representation rights of a company and this can affect the liabilities undertaken by directors in the name of the company. However, with respect to contracts, following Regulation (EC) No 593/2008 (Rome I)[162] the parties' choice of the applicable law will be the first point to look at.

[158] Civil Law 1937, s 20
[159] Council Regulation (EC) 864/2007 on the law applicable to non-contractual obligations (Rome II)
[160] Council Regulation (EC) 1346/2000 on insolvency proceedings [2000] OJ L160/1
[161] Council Regulation (EC) 1346/2000 on insolvency proceedings [2000] OJ L160/9, Art 3
[162] Council Regulation (EC) 593/2008 on the law applicable to contractual obligations (Rome I)

Directors' Duties and Liability in Lithuania

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CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in Lithuania

The legal framework of corporate law in Lithuania is statute-based. The main legal acts regulating corporate law in Lithuania are:

- Civil Code of the Republic of Lithuania (in Lithuanian – *Lietuvos Respublikos civilinis kodeksas*) (the "Civil Code")[1]. The second Book of the Civil Code in particular sets out general rules both on the incorporation of legal entities and on the ways in which they should be run. These rules are applicable to every legal entity unless otherwise provided for by separate laws regulating specific forms of the legal entities;
- Law on Companies of the Republic of Lithuania (in Lithuanian – *Lietuvos Respublikos akcinių bendrovių įstatymas*) (the "Law on Companies")[2] sets out specific rules both on the incorporation of public limited companies (in Lithuanian – *akcinė bendrovė* or *AB*) and private limited companies (in Lithuanian – *uždaroji akcinė bendrovė* or *UAB*), and on how they should be run. Public limited companies and private limited companies are mainly treated exactly the same. If the Law on Companies provides different requirements for the public limited companies and private limited companies, it is clearly indicated in the Law;
- laws regulating other forms of legal entities: Law on Partnership of the Republic of Lithuania (in Lithuanian – *Lietuvos Respublikos ūkinių bendrijų įstatymas*);[3] Law on Private Entities of the Republic of Lithuania (in Lithuanian – *Lietuvos Respublikos individualių įmonių įstatymas*);[4] Law on Agricultural Companies (in Lithuanian – *Lietuvos Respublikos žemės ūkio bendrovių įstatymas*)[5]; Law on State and Municipal Enterprises of the Republic of Lithuania (*Lietuvos Respublikos* valstybės ir savivaldybės įmonių įstatymas);[6] and other laws regulating separate forms of legal entities;[7]
- laws regulating specific sectors: Law on Banks of the Republic of Lithuania (in Lithuanian – *Lietuvos Respublikos bankų įstatymas*);[8] Law on Insurance of the Republic of Lithuania (in Lithuanian – *Lietuvos Respublikos draudimo įstatymas*)[9]; Law on Securities of the Republic of Lithuania (in Lithuanian – *Lietuvos Respublikos vertybinių popierių įstatymas*) – ("Law on Securities")[10]; and Law on Markets in Financial Instruments of the Republic of Lithuania (in Lithuanian – *Lietuvos Respublikos finansinių priemonių rinkos įstatymas*)[11] set specific rules related to the companies acting in bank, insurance and capital market sectors.

In addition to the statutes mentioned above, listed companies are also subject to the rules of "The Corporate Governance Code for the Companies Listed on NASDAQ OMX Vilnius",[12] approved by the

[1] Law Number VIII-1835, 13 July 2000, as amended.
[2] Law Number I-528, 5 July 1994, as amended.
[3] Law Number IX-1804, 6 November 2003, as amended.
[4] Law Number IX-1805, 6 November 2003, as amended.
[5] Law Number IX-330, 17 May 2001, as amended.
[6] Law Number I-722, 21 December 1994, as amended.
[7] However these forms of legal entities do not fall under the scope of this report and will not be analysed.
[8] Law Number IX-2085, 30 March 2004, as amended.
[9] Law Number IX-1737, 18 September 2003, as amended.
[10] Law Number X-1023, 18 January 2007, as amended.
[11] Law Number X-1024, 18 January 2007, as amended.
[12] Henceforth the *"Code"*; available at:
<http://www.nasdaqomxbaltic.com/files/vilnius/teisesaktai/The%20Corporate%20Governance%20Code%20for%20the%20Com

Lithuanian Securities Commission and Board of the NASDAQ OMX Vilnius in December 2009. The code contains a statement of best practices in relation to the composition and tasks of the board of directors and the supervisory board of companies whose securities are admitted to the Official, Secondary or Debt Securities Trading List of NASDAQ OMX Vilnius.[13]

While the Code itself is not binding, the Law on Securities requires an annual statement of how a listed company has applied the main principles of the code. This statement should explain whether the company has complied with the principles and if it has not, then reasons must be given for non-compliance.[14]

The case law is a secondary law source in Lithuania. It has to be noted, however, that until recently judicial proceedings dealing with directors' duties have been relatively rare. Over the course of the last few years, however, the judicial activity has been picking up. This is partly due to an increase in corporate insolvencies, which led insolvency administrators to initiate proceedings against former directors on the basis of alleged breaches of their duties.

Directors' duties have not yet received as much attention in Lithuanian academic literature as in some of the other EU Member States, but there exist some treatises on the topic.[15]

1.2 Corporate landscape in Lithuania

The capital market in Lithuania is still relatively young. The main trading venue for shares in Lithuanian listed companies is the Vilnius stock exchange (NASDAQ OMX Vilnius), which was founded in 1993.[16] NASDAQ OMX Vilnius forms part of the NASDAQ OMX Group, one of the largest stock exchange operators in the world. There are two trading segments on the Vilnius stock exchange, the main list and the secondary list. Companies on the main list are subject to a number of additional requirements, including with respect to its capitalization and free float.

Currently, there are 33 companies listed and traded on the Vilnius stock exchange (18 of which are listed on the main list 15 on the secondary list). As of 14 December 2012, the total market capitalization of the shares listed on NASDAQ OMX Vilnius amounted to around EUR 3 billion.[17]

According to the Law on Companies a company may be incorporated in the form of a public limited company or a private limited company. The share capital of both public limited and private limited companies is divided into shares. Private limited companies are subject to a minimum share capital of is LTL 10,000 (approx. EUR 2,897),[18] while public limited companies are required to have a

panies%20Listed%20on%20NASDAQ%20OMX%20Vilnius%20%28effective%20as%20of%202010-01-01%29.pdf>; last accessed 14 December 2012.

[13] For issuers whose securities are traded on Multilateral Trading Facilities or in "equal trading segments", the application of the Code provisions is also recommended; see p. 3 of the Code.

[14] Article 21 (3) of the Law on Securities.

[15] Abramavičius A., Mikelėnas V., *Įmonių vadovų teisinė atsakomybė* (Teisinės informacijos centras 1998); Rimgaudas Greičius, *Privataus juridinio asmens vadovo fiduciarinės pareigos* (Teisinės informacijos centras 2007).

[16] See the description at http://www.nasdaqomxbaltic.com/en/exchange-information/about-us/nasdaq-omx/nasdaq-omx-vilnius-3/history-4/, last accessed 14 December 2012.

[17] See the exchange listing at: http://www.nasdaqomxbaltic.com/market/?pg=capital&list%5B%5D=BAMT&list%5B%5D=BAIT&list%5B%5D=BAFN&market=XVSE&period=day&start_d=13&start_m=12&start_y=2012&end_d=14&end_m=12&end_y=2012; last accessed 14 December 2012.

[18] Article 2 (4) of the Law on Companies

subscribed share capital of at least LTL 150,000 (approx. EUR 43,443).[19] There is no minimum requirement regarding the number of shareholders for either type of companies. However, a private limited company must not have more than 250 shareholders.[20]

The most popular legal form for Lithuanian companies is the private limited company. At the beginning of 2012, over 49,000 private limited companies were in operation, compared to only 327 public limited companies.[21] In the following part of the report, reference is made to the framework applicable to both public and private limited companies (as they are governed by the same law, cf. above) if not stated otherwise.

1.3 The board of a Lithuanian company

There are two corporate organs any company must have under Lithuanian law: the company manager, who must be a natural person, and the General Meeting.[22] The company manager has sole representation power to act on behalf of a company,[23] unless the articles of association of a company provide for joint representation, in which case the company manager may only act on behalf of the company together with one or more other members of the management organ (e.g. or a procura holder).[24]

Under Lithuanian law a company may also have the following optional bodies: a collective managing body – the board – and/or a collegial supervisory organ – the supervisory board.[25] Where a supervisory board is not established in a company, the functions of the supervisory board provided in the Law on Companies are not transferred to any other body of a company. On the other hand, if no board is formed, the board's functions shall be performed by the company manager, with the exception of the appointment and dismissal of the company manager, which power rests with the general meeting.

In practice, the most popular corporate governance structure consists of the company manager, a board of directors and the shareholders' meeting ("one-tier" structure). However, public limited companies whose shares are listed on the stock exchange typically make use of the right to establish the aforementioned optional corporate bodies. Thus, the organs of a listed company are the company manager, the board, the supervisory board and the shareholders' meeting. While the classical "two-tier" structure consists of two separate bodies – the board of directors and the supervisory board –, under Lithuanian law the company manager is a separate body, and the person appointed as company manager may or may not be a member of the board of directors.

Lithuanian law does not provide for mandatory employees participation on any of the company's bodies.

According to Article 19 (8) of the Law on Companies, the management bodies of a company must act *"only for the benefit of the company and its shareholders"*, as well as comply with the applicable laws

[19] Article 2 (3) of the Law on Companies
[20] Article 2 (4) of the Law on Companies
[21] Source: *Lietuvos statistikos departamentas*, "Number of registered and in operation economic entities by legal form, statistical indicator and year", available at http://www.stat.gov.lt/en/; last accessed: 1 December 2012.
[22] Article 19 (1) of the Law on Companies
[23] Article 19 (6) of the Law on Companies
[24] Article 19 (7) of the Law on Companies
[25] Article 19 (2) of the Law on Companies

and regulations and the company's articles of association. In addition, Article 37 (7) of the Law on Companies mandates compliance with decisions of the shareholders' meeting, the supervisory board and the board of directors. The wording of the provision suggests, in particular, that shareholders can give binding directions to the company manager. The Supreme Court of Lithuania, however, in interpreting this provision, clarified that this provision does not relieve the managing bodies of their duty to act in the interest of the company.[26] Recognising that the shareholders' interests and the interests of the company may diverge in certain situations, the Supreme Court held that the managing bodies of the company must *not* comply with instructions by the shareholders where doing so would be against the interests of the company.

[26] Decision of the Lithuanian Supreme Court passed in the civil case *AB "Barklita" v. G.B. and J.G.*, case No. 3K-3-528/2009

2 The concept of 'company director' in Lithuania

Lithuania law does not provide a general definition of 'company director'.[27] In different legal acts the concept of a company director is different:

- in some legal acts only the company manager is considered a director;[28]
- in other legal acts, the company manager and the members of a collective managing body (board of directors) are considered directors of a company; [29]
- according to another approach, any person who, in accordance with a financial institution's founding documents, resolutions of the board and in accordance with the relevant procedural rules, is authorised to take independent decisions on the provision of financial services and conclude, on behalf of the financial institution, certain transactions specified in the relevant financial services legislation.

  The persons that can be considered as director are: members of the supervisory board, members of the board of directors, the controller, company managers, employees of financial institutions, and the head of the internal audit department.[30]

According to the relevant academic literature, the members of any bodies of the corporate bodies, except the shareholders, should be considered directors (i.e. the company manager, members of the board of directors and members of the supervisory board).[31]

In this report the term "director" will be used to refer to the company manager, members of the collective managing body (board of directors) and supervising body (supervisory board).

2.1 De jure directors

The term "de jure director" will be used here to describe directors who have been validly appointed in accordance with the Law on Companies and the relevant provisions of the articles of association.

Lithuanian law does not distinguish between different types of directors in relation to the fiduciary duties they owe. It is also worth noting that the individual directors, not the collegial body as such, owes duties and responsibility on directors. Nevertheless, the liability of directors is joint and several in cases of common breaches of fiduciary duties by several directors.

No special rules apply to directors of companies belonging to a group of companies, meaning that such directors owe the same duties to the company as directors of "independent" (i.e. non-controlled) companies.

[27] Rimgaudas Greičius, n 15 above, p 109.
[28] E.g. Article 2 (22) of the Law on Accounting, Law Number IX-574, 6 November 2001, as amended.
[29] Article 2.87 (1-5) of the Civil Code
[30] Article 20 of the Law on Financial Institutions
[31] Rimgaudas Greičius, n 15 above, p 112.

2.1.1 Members of the supervisory board

The members of the supervisory board of a company are elected by the shareholders' meeting. The number of members of the supervisory board shall be specified in the company's articles of association; however, the supervisory board must have at least three, and may not have more than fifteen members. The terms of supervisory board members may also be specified in articles of association of a company, subject however to a statutory maximum term of four years.[32] Supervisory board members may, however, be re-appointed without limitation.

Generally, any natural or legal person may be appointed to the supervisory board.[33] However, the company manager as well as members of the board of directors cannot be appointed to the supervisory board. Likewise, (natural or legal) persons may be excluded from serving as directors by the applicable laws and regulations[34] (e.g. persons subject to a disqualification order).

The supervisory board shall continue in office for the period provided in the article of association or until a new supervisory board is elected, but no longer than until the date of the annual general meeting held during the final year of their term of office.

The members of the supervisory board shall commence their activities after the end of the general meeting in which they are appointed. Where a supervisory board is newly established in a company by amending the articles of association, the newly elected supervisory board members may not assume office until the change has been registered with the Register of Legal Entities. Where the articles of association are amended in order to increase the size of the supervisory board, directors filling the newly created supervisory board seats shall likewise only assume office once the relevant amendment of the articles has been filed with the Register.

The general meeting may at any time remove the entire supervisory board or individual supervisory board members. A member of the supervisory board may also resign from office before the expiry of the term of office by giving a written notice to that effect at least 14 days in advance. If a member of the supervisory board is removed from office, resigns or discontinues the performance of his duties for other reasons and shareholders holding at least 10% of the voting rights object to the election of individual members of the supervisory board, the entire supervisory board shall stand for re-election. Where vacancies on the board of directors are filled, the terms of the newly elected members shall end at the same time as the terms of the current supervisory board members.

2.1.2 Members of the board of directors

Where a supervisory board has been established, the members of the board of directors of the company shall be appointed by the supervisory board. Where no supervisory board exists in the company, the shareholders' meeting shall appoint the members of the board of directors. The number of members of the board of directors shall be specified in the articles of association, but the board

[32] Article 31 (4) of the Law on Companies
[33] Article 2.81 (4) of the Civil Code
[34] Article 31 (6) of the Law on Companies

must have at least three members. The terms of the board members must not be longer than four years.[35]

Only a natural person may be elected as member of the board of directors. As stated above, cross-membership between the supervisory board and the board of directors is prohibited. As with the supervisory board, certain persons may not be appointed as directors. This applies in particular where a person has been disqualified by the courts in accordance with the applicable laws.[36] Members of the board of directors may be re-elected without limitation of the number of consecutive terms.

The board of directors shall perform its functions for the period laid down in the articles of association or until a new board of directors is elected and commences its activities. In any event, the term of office shall end after the annual general meeting held during the final year of the term.

The members of the board shall commence their activities after the end of the general shareholders' meeting or, where appointed by the supervisory board, after the end of the relevant supervisory board meeting at which they were elected. Where a board of directors is newly established by amending the articles of association, the board members may not assume office until the change has been registered with the Register of Legal Entities. The same applies to increases of the size of the board of directors through an amendment of the articles; directors filling the newly created board seats must not assume office until the relevant filings have been made.

The supervisory board (or, where no supervisory board is formed, the general meeting) may remove members of the board of directors or the entire board before the expiry of their respective terms of office. A member of the board of directors may resign from office prior to the expiry of his term of office upon giving a written notice thereof to the company at least 14 days in advance.

2.1.3 The 'company manager'

The company manager shall be appointed to or removed by the board of directors or, if no board of directors is established, by the supervisory board. If neither a supervisory board nor a board of directors has been established in a company, the general shareholders' meeting shall appoint the company manager. The company manager shall assume office after the election, unless otherwise provided for in the employment contract concluded with him. Only natural persons can be appointed company managers. Members of the supervisory board cannot at the same time hold the position of company manager.

The board of directors (if the board of directors is not formed, the supervisory board, if the supervisory board is not formed, the general shareholders' meeting) may remove the company manager at any time without cause, unless a notice period is provided for in the employment contract concluded between the company manager and the company. If the company manager is elected by the board of directors or the supervisory board of the company, the company manager may resign from the office upon giving a written notice thereof to the body that elected the company manager. Such notice must be given at least 14 days in advance. The board of directors or the supervisory board has to take a decision to remove the company manager within 15 days after receiving the written notice. If the board of directors or the supervisory board does not resolve on removing the company manager from office within 15 calendar days after the written notice is received, the employment agreement between the

[35] Article 33 of the Law on Companies
[36] *Ibid.*

company manager and the company shall be considered terminated on the sixteenth day after the written notice of the company manager was received.

Where the company manager was elected by the general shareholders' meeting, the company manager is obliged to convene a general meeting to resolve on his removal and the election of a new company manager. In case the general shareholders' meeting does not recall the company manager at that meeting, the term of the company manager shall end on the day following the general shareholders' meeting (or after a re-called general meeting of shareholders, if the general shareholders' meeting was not held).[37]

2.2 De facto and shadow directors

Lithuanian law does not contain explicit provisions with so-called de facto or shadow directors. So far, there exists no case law on this topic, although the issue has been dealt with in the academic literature.

[37] Article 37 of the Law on Companies

3 THE SCOPE OF DIRECTORS' DUTIES UNDER LITHUANIAN LAW

3.1 Types of directors' duties

The directors' duties are provided in the Civil Code and legal acts regulating specific forms of legal entities.[38] Directors' duties are also addressed in the Corporate Governance Code.[39]

The main fiduciary duties of the directors are provided in Article 2.87 of the Civil Code:

- duty to act with reasonable care;
- duty to act in good faith;
- duty to be loyal to the legal entity;
- duty to avoid conflict of interest;
- duty to avoid confusing the property of a legal entity with the property of the director;
- duty to declare interest in proposed transaction or arrangements.

3.1.1 Duty to act with reasonable care

The Civil Code provides that the members of the company's bodies should act with reasonable care.[40] This means that a director has to meet the standard of care and diligence expected from a prudent and experienced director, performing the functions and having the tasks of the director in question. Thus, the relevant question is how a prudent and experienced director would have acted in the same situation, and whether the actual behaviour of the director in question falls below that standard.[41]

Apart from this objective standard, a director also has to meet a subjective standard in order to comply with the duty of care. Here, the assessment of the director's actions take into account subjective elements such as the director's age, the level of education, and the actual experience the director possesses.[42] The same position is expressed in the case law of Lithuanian Supreme Court.[43]

3.1.2 Duty to act in good faith

Article 2.87 (1) of the Civil Code provides that members of the management bodies of the company shall act in good faith for the benefit and in the interests of the company and other members of the company's bodies. However, the members of a company's bodies should act in good faith not only for

[38] See Article 2.87 of the Civil Code.
[39] Article 1.2, 4.2 - 4.4 and 7.1 -7.4 of the Code.
[40] Article 2.87 (1) of the Civil Code
[41] Rimgaudas Greičius, n 15 above, p 148.
[42] *Ibid.*
[43] Decision of the Lithuanian Supreme Court passed in the civil case *L. Bielinskaja v. ADB "Snoro garantas" and AB bankas "Snoras"*, case No. 3K-3-880/2002

the benefit and in the interests of the company and its shareholders, but also have to take into account the interests of employees as well as the public interest.

3.1.3 Duty to be loyal to the legal entity

According to the Civil Code, member of the company's bodies have to be "loyal" to the company.[44] The exact meaning of loyalty, in this context, is not further specified in the Civil Code, and it is thus left to the courts and, to some extent, legal commentators to interpret the exact scope of this duty. The jurisprudence of the Supreme Court of Lithuania is somewhat ambiguous in this respect. In some cases the duty of loyalty is related to the director's duty to avoid conflict of interests,[45] in other cases the Supreme Court highlights the duty to act in compliance with the company's constitution and with the decisions of other bodies of the company.[46]

In scholarly writing the duty to be loyal to the company has been interpreted as a duty to act for the benefit and in the interests of the company, its shareholders, creditors, employees and in the public interest; it is thus closely connected and overlaps with the duty to act in good faith described above.[47]

3.1.4 Duty to avoid conflict of interest

According to Article 2.87 (3) of the Civil Code a member of the company's managing body has to avoid a situation where his personal interests are contrary or may be contrary to the interests of the company. In particular, a director is prohibited from appropriating the company's property and using the property or the information which he obtains in the capacity as director for his personal (or another person's) person's gain, unless the director first obtains the approval of the general shareholders' meeting.[48] The Civil Code[49] also imposes an obligation on the directors to inform the company of any possible conflict of interest. According to the Article 2.87 (5) of the Civil Code a member of a managing body of a company must notify other members of the managing body or shareholders of the company about the circumstances where his personal interests are contrary or may be contrary to the interests of the company and define their nature and, where applicable, quantify the financial interest of the director. Such information must be provided in writing or included into the minutes of the meeting of company's bodies.

The Law on Companies also provides that every candidate for the office of the company manager, member of the board of directors or supervisory board must inform the relevant appointing body of all other position he or she holds, how these other positions or activities are connected to the activities of the company and other legal entities related to the company.[50] Moreover, a member of the board of directors is not entitled to vote on matters related to the director's performance or regarding the director's own liability.

[44] Article 2.87 (2) of the Civil Code
[45] Decision of the Lithuanian Supreme Court passed in the civil case *V. Savickas v. J. Sriubaitė ir kt.*, case No. 3K-3-353/2002, 26 November 2003; decision of the Lithuanian Supreme Court passed in the civil case *L. Bielinskaja v. ADB "Snoro garantas" and AB bankas "Snoras"*, case No. 3K-3-880/2002; Decision of the Lithuanian Supreme Court passed in the civil case *A. Kvietkauskas v. UAB "Interarbo"*, case No. 3K-3-192/2004.
[46] Decision of the Lithuanian Supreme Court passed in the civil case *UAB "Khartli" v. UAB "Diagnostikos poliklinika*, case No. 3K-3-16/2005, 7 February 2005.
[47] Rimgaudas Greičius, n 15 above, p 176.
[48] Article 2.87 (4) of the Civil Code

[50] Article 19 (9) of the Law on Companies

According to the Lithuanian law, the directors of the company may enter into contracts with the company. However, in such cases the director must follow the rules provided in the constitutional documents of the company as well as any other internal documents of the company and with the provisions of the Civil Code. In particular, the Civil Code provides that a director must without delay notify other bodies or shareholders of the company about the contract (such information must be provided in writing or included into the minutes of the meeting of company's bodies) if incorporation documents of the company fail to provide explicitly for a different procedure of notification.[51]

3.2 To whom are the duties owed?

According to the Civil Code the director owes duties to the company and members of other bodies of the company.[52]

3.3 The director as a shareholder

Lithuanian law does not provide for specific duties that apply to directors who hold shares in the company. Under certain circumstances, however, the shareholding of the director may lead to a conflict of interest; in such cases, the obligation to disclose the conflict of interest described above applies.

3.4 The time span of the duties

Directors' duties begin after the director is appointed to his position and terminate after the term of the office expires. Directors' duties terminate before the regular term of the office expires,[53] if:

- a director resigns from the office before the term of the office expires;
- a director is removed from the office by the decision of the respective body of the company;
- a court removes or disqualifies a director from the office.

3.5 Application of duties to de facto and shadow directors

The liability of company directors for breach of their duties is only explicitly regulated in relation to de jure directors. Neither de facto nor shadow directors fall under the express provisions of Lithuanian company law. To date, a possible extension of the liability provisions to persons who have not formally been appointed as directors – whether shadow or de facto directors – has not been tested in the Lithuanian courts. It cannot, therefore, be assessed with any degree of certainty whether Lithuanian courts will extend the application of the provisions described in this report to such persons.

[51] Article 2.87 (6) of the Civil Code
[52] Article 2.87 (1) of the Civil Code. As mentioned in section 3.1.3 above, the directors have to act for the benefit and in the interests of the company, its shareholders, creditors, employees and in the public interest, but this duty is owed to company.
[53] See section 2.1 above

4 LIABILITY FOR BREACH OF DUTY

4.1 Conditions for liability

According to the Civil Code,[54] directors who fail to perform, or perform improperly, their duties provided in Article 2.87 of the Civil Code or set out in the articles of association of the company must compensate the company for all damages suffered due to the breach of the directors' duties, unless otherwise provided by law, articles of association or a valid agreement. Under this provision only a member of a managing body of a company (i.e. a member of a board of directors and the company manager) may be held liable for a breach of fiduciary duties.

A director may be held liable for the breach of fiduciary duties if the following conditions are met:

- unlawful actions: a director fails to perform or performs improperly his fiduciary duties;[55]
- causality between unlawful actions and damage suffered by the company;[56]
- fault: civil liability shall arise only upon the existence of the fault of the liable persons, except in the cases established by laws or a contract when the strict liability is applied. Fault may exist where the director acts intentionally or negligently. A person shall be deemed to have committed fault where taking into account the essence of the obligation and other circumstances he failed to behave with the care and prudent necessary in the corresponding conditions;[57]
- damage: the liability only arises where the company has suffered damage. Damages to the company may, in principle, also include forgone profits of the company.[58] The claimant bears the burden of proof in relation to the existence of an unlawful action and the causality between this unlawful action and the damage suffered by the company. According to the Civil Code, where the existence of an unlawful action has been proven, the subjective element (i.e. fault) on the part of the defendant is presumed.[59] Thus, the director bears the burden of proof in relation to the absence of fault.

4.2 Exemptions and limitations

As mentioned above, Article 2.87 (7) of the Civil Code explicitly states that the liability only attaches, if not provided otherwise by law, the articles of association or an agreement. Thus, it seems that the limitation of a director's liability for breach of his or her duties in the company's articles is possible. Furthermore, an agreement between the company and the director, indemnifying the director in respect of his liability for a breach, as well as agreements capping and/or limiting the liability is, in principle, enforceable. This does not, however, apply to agreements purporting to cap, limit or exclude the liability for a grossly negligent breach of directors' duties. According to Article 6.252 of the Civil Code, agreements may not limit the liability for grossly negligent breaches.

[54] Article 2.87 (7) of the Civil Code
[55] Article 6.246 of the Civil Code
[56] Article 6.247 of the Civil Code
[57] Article 6.248 of the Civil Code
[58] Article 6.249 of the Civil Code
[59] Article 6.248 (1) of the Civil Code

According to the case law of Lithuanian courts the ratification of an action by the shareholders' meeting does not exclude or limit directors' liability for the damage caused by the breach of directors' duties.[60]

It is also necessary to consider the Lithuanian version of what is often referred to as the "business judgment rule". The concept was developed in the relevant case law.[61] According to the business judgment rule the director is excluded from liability if his taken decision complies with the requirements of the legal act, does not exceed normal economic risk and is not obviously loss-making to the company.[62]

4.3 Insurance against liability

Directors' civil liability insurance (D&O insurance) is permissible under Lithuanian law.[63] Typically directors' civil liability insurance is divided into two parts:

- damage to third parties arising from the improper director's actions;
- damage to the company caused by inappropriate director's actions. Director's civil liability insurance typically also covers the necessary legal costs of the defendant. Director's civil liability insurance is not widespread in Lithuania yet, which may however be in a process change, particularly with regard to larger and listed companies.

4.4 Consequences of liability

4.4.1 Damages

Under Lithuanian law any unlawfully caused damage has to be compensated in full, except in cases where liability is limited according to the applicable law, the articles of association or in a valid contract. Where awarding compensation in full would lead to unacceptable and grave consequences for the defendant, the court may, at its discretion, reduce a defendant's liability. In doing so, courts shall take into account the nature of the liability, the financial situation of the parties, and their relationship. The reduction may not, however, be exercised in so far as the director is covered by insurance.[64]

4.4.2 Invalidity/voidability of transactions

The court may declare decisions of the bodies of a legal entity (decisions of the general shareholders meeting, the supervisory board, the board of directors and decision of the company manager) void, if such decisions are contrary to mandatory provisions of the law, the articles of association or principles of reasonableness and good faith.[65] According to Article 2.82 (4) of the Civil Code the action may be initiated by the creditors of a legal entity, one of the corporate bodies, by shareholders or other stakeholders of a legal person or by other persons prescribed by the law, provided that the decision

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[60] Decision of the Lithuanian Supreme Court passed in the civil case *AB "Barklita" v. G.B. and J.G.*, case No. 3K-3-528/2009
[61] Decision of the Lithuanian Supreme Court passed in the civil case *Vokietijos bendrovė "Gretsch – Unitas Gmbh" and UAB "Gretsch – Unitas Baltic" v. V. Semeška*, case No. 3K-3-1590/2002
[62] Rimgaudas Greičius, n 15 above, p 149.
[63] Article 6.254 of the Civil Code
[64] Article 6.251 of the Civil Code
[65] Article 2.82 (4) of the Civil Code

infringes their respective rights or interests. According to the Law on Companies, such action may be initiated within 30 days from the day on which the plaintiff first had notice, or ought to have had notice, of the contested decision.[66]

4.4.3 Contracts exceeding authority

Article 2.81 (3) of the Civil Code provides that shareholders of the company have the right to bring an action requesting the court to prevent the managing bodies of the company (the company manager and/or board of directors) from entering into contracts which run counter to the interests of the company or which exceed the authority of the respective corporate body. The right to bring an action under this provision is not tied to any specific ownership threshold; thus, any single shareholder may initiate the above mentioned proceedings.

4.4.4 Investigation of directors' activities

Article 2.124 of the Civil Code provides that shareholders holding at least 10% of a company's capital have the right to request the court to appoint independent experts in order to "investigate whether a legal person or legal person's managing bodies or their members acted in a proper way". In the event that it is established that improper actions had taken place, the court may decide[67]

- to invalidate the decisions taken by the managing bodies of the company. A decision to revoke decisions of the managing body of the legal entity may not, however, be taken if the period of limitation of actions prescribed by laws has expired;
- to suspend temporarily the powers of the members of the managing bodies of the company or exclude a person from the managing body of the legal entity;
- to appoint temporary members of the members of the managing bodies of the relevant company;
- to authorise non-implementation of certain provisions in the articles of association;
- to order certain changes to the articles of association;
- to transfer temporally the right to vote of the member of the managing body of the relevant company to another person;
- to order the relevant company to take or not to take certain actions;
- to wind up the company and appoint a liquidator. A decision to wind up a legal entity may not be taken where such decision would counteract the interests of other shareholders or stakeholders and/or the employees of the company members, or where such decision would be against the public interest.

4.4.5 Personal liability in case of excess of authority (private company)

If the managing bodies of a private limited company enter into agreements that exceed their authority, such contracts will still be binding on the company, unless the other party to the contract was aware, or, based on the specific circumstances, must have been aware of the excess of the director's authority.[68] However, to the extent that the company fails to satisfy fully the claim of the other party of

[66] Article 19 (10) of the Law on Companies
[67] Article 2.131 (1 – 3) of the Civil Code
[68] Article 2.83 (1) of the Civil Code

the agreement, the person acting on behalf of the company (e.g. the company manager) under the circumstances described above will be liable to the other party to the agreement jointly with the company.

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 The meaning of 'vicinity of insolvency'

Lithuanian law does not contain a definition of the 'vicinity of insolvency' (or similar). However, the criteria determining the point in time at which it is possible to file for insolvencyprovide some guidance as to the relevance of a 'vicinity of insolvency'-phase in Lithuanian company law.

The creditor, the owner[69] or the company manager may file a petition for bankruptcy if at least one of the following conditions is present:[70]

- a company fails to pay wages and other employment related amounts when due;
- a company fails to pay, when due, for the received goods, performed work or provided services, defaults in the repayment of credits and does not fulfil other obligations undertaken under contracts;
- a company fails to pay, when due, taxes, other compulsory contributions prescribed by the laws and/or the awarded sums;
- a company has made a public announcement or notified the creditor /creditors in any other manner of its inability or lack of intent to discharge its obligations;
- a company has no assets or income from which debts could be recovered and therefore the bailiff has returned the writs of execution to the creditor.

A company will be considered insolvent if it fails to satisfy claims of its creditors within three month of the claim falling due.

5.2 Change of existing duties

Existing duties of directors do not change in the vicinity of insolvency. However, the company manager has an obligation to file a petition to initiate a bankruptcy procedure as soon as possible. If the director fails to act accordingly, he will be liable for the damage suffered by the creditors of the company due to the delay in filing for bankruptcy.

[69] According to Article 2 (9) of the Law on Bankruptcy of Enterprises (Law Number IX-216, 20 March 2001, as amended) the owner of the company means the owner/owners of an individual/personal enterprise, a member/members of a general partnership, a general member/general members or a limited member/limited members of a limited partnership, the founder of a state-owned or municipal enterprise, a shareholder/shareholders whose shares carry over 10% of voting rights, a holder/holders of member share, stakeholders in a public agency.
[70] Article 4 of the Law on Bankruptcy of Enterprises

5.3 Newly arising duties

5.3.1 Duty to file for bankruptcy

Under Article 8 of the Law on Bankruptcy of Enterprises the owner(s) of the company and the company manager must file a petition for the initiation of the bankruptcy proceedings for the company, if the company is or will be unable to settle with the creditors and the creditors have not filed a petition for bankruptcy to a court or the company has notified the creditors of its inability or lack of intent to discharge its obligations. If the company manager or the members of the board of directors fail to file for insolvency in good time, they will be liable for the damage suffered by the creditors of the company due to the delay in filing for bankruptcy.[71]

5.3.2 Duties after commencement of bankruptcy proceedings

Insolvency proceedings shall be instituted[72] if the court establishes that (i) either the company is insolvent;[73] or, (ii) the company has notified the creditors of its inability to effect settlement or of its lack of intent to do so.

Thereafter, the managing bodies of the company must transfer to the insolvency administrator the assets of the company according to the financial accounts drawn up on the basis of the data as of the day of institution of the insolvency proceedings and all pertinent documents within the time limits set by the court.[74] Directors lose their powers once the court order opening the insolvency proceedings comes into force.[75] The insolvency administrator shall terminate the employment or service contracts with the members of the board of directors and the company manager, subject to a fifteen day notice.

[71] Article 8 (4) of the Law on Bankruptcy of Enterprises
[72] Article 9 (5) of the Law on Bankruptcy of Enterprises
[73] i.e. the state of a company when it fails to settle with the creditor/creditors after the lapse of three month from the deadline prescribed by laws, other legal acts as well as by the agreements between a creditor and the company for the discharge of the obligations of the enterprise, or upon expiry of the said time period after the creditor/creditors demands/demand the discharge of the obligations where the deadline has not been set in the agreement, and the overdue obligations/debts are in excess of over a half of the value of the assets on the company's balance
[74] According to the case law of Lithuanian courts, if the managing bodies of the company fails to transfer to the bankruptcy administrator the assets of the company according to the financial accounts drawn up on the basis of the data as of the day of institution of the bankruptcy proceedings and all pertinent documents within the time limits set by the court due to fact the assets of the company are not in the company, the members of managing bodies will be liable for such damage and will have to compensate such damage to the company (Vilnius County Court decision in case No 2-1743-798/2011 (at the moment of drafting this report the court decision is not in force due to the appeal proceedings)).
[75] Under Article 85 (3(1)) Law on Banks, the managing bodies of the bank lose their powers after the court order to institute bankruptcy proceedings is passed.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue

The proceeding under Article 2.87(7) of the Civil Code may be initiated by the company itself as well as by shareholders of the company.[76] The company may be represented only by the company manager[77] or, in the case of the quantitative representation rule provided in the articles of association of the company, the company manager with one of the members of the board of directors or procura holder.[78] Therefore in practice this action may be initiated by company only if it is initiated against the company manager who is not the company manager any more or the action is initiated against the member of the board of directors.

Claims against directors for breach of duties have to be enforced within three years. The three year period is calculated from the point in time at which the damage became known or should have been known to the plaintiff.[79]

Under Article 2.124 of the Civil Code, the following persons enjoy the right to apply to the court for investigation of the activities:[80]

- a shareholder or a group of shareholders of a legal entity holding or managing shares the par value of which accounts for not less than 10% of the issued share capital of the legal entity;
- a partner or a group of a partners of a partnership whose interest accounts for not less than 1/10 of all interest;
- in other cases shareholder or stakeholders of a legal person who have not less than 1/5 of all votes;
- the persons as well as shareholder or stakeholders of a company, provided that articles of association provide so. The company can also contractually provide the right to apply for the investigation procedure to any third party.

The public prosecutor also is entitled to apply for an investigation into the company's affairs in order to protect the public interest, including in cases where the activities of a company, its managing bodies or its members are contrary to the public interest.

[76] Article 19 (5) of the Law on Companies
[77] Article 19 (6) of the Law on Companies
[78] Article 19 (7) of the Law on Companies
[79] Article 1.125 (8) of the Civil Code
[80] Article 2.125 of the Civil Code

6.2 Criminal and administrative sanctions

6.2.1 Directors' criminal liability

Directors could also be liable under criminal[81] law. The Penal Code does not directly provide criminal liability for the breach of the fiduciary duties of the directors. However, in some cases a breach of fiduciary duties also constitutes a criminal act.

Examples for cases in which a breach of directors' duties also constitutes a criminal offence are the following:

- According to Article 205 (1) of the Lithuanian Penal Code, "a person who, on behalf of a legal entity, presents in an official report or in an application misleading data concerning the activities or assets of the legal entity and thereby misleads a government institution, international public organisation, creditor, shareholder or stakeholder of the legal entity or another person who suffers major property damage [i.e. the value of the damage is more than LTL 19,500 (approx. EUR 5,650)] shall be punished by deprivation of the right to be employed in a certain position or to engage in a certain type of activities or by restriction of liberty or by arrest or by imprisonment for a term of up to two years";[82]
- moreover, "a person who brings an undertaking to bankruptcy by deliberate mismanagement and thereby incurs major property damage [defined as above] to creditors shall be punished by imprisonment for a term of up to three years";[83]
- "a person who discloses the information considered to be a commercial secret which was entrusted to him or which he accessed through his service or work, where this act incurs major property damage [defined as above] to the victim shall be punished by public works or a fine or by restriction of liberty or by arrest or by imprisonment for a term of up to two years";[84]
- "a person who, having access to a non-disclosed information about the events essential for the issuer or other non-disclosed information relating to the issuer or securities thereof, enters into a transaction on the securities of this issuer directly or via intermediaries of public trading in securities or communicates this information to third parties or recommends or offers third parties to acquire or to convey the securities of the issuer whereto the non-disclosed information is related to, where this incurs major property damage, shall be punished by restriction of liberty or by a fine or by imprisonment for a term of up to two years";[85]
- "a person who, seeking to increase arbitrarily or reduce the market price of securities, circulates a false or incomplete information regarding the issuer or securities thereof and thereby incurs major property damage shall be punished by restriction of liberty or by a fine or by imprisonment for a term of up to three years."[86]

6.2.2 Disqualification of directors

Provisions regulating disqualification of directors may be found in different legal acts, such as Law on Bankruptcy of Enterprises, Penal Code or Civil Code.

[81] Criminal liability is provided in the Penal Code of the Republic of Lithuania
[82] Article 205 of the Penal Code
[83] Article 209 of the Penal Code
[84] Article 211 of the Penal Code
[85] Article 217 of the Penal Code
[86] Article 218 of the Penal Code

Article 10 (14) of the Law on Bankruptcy of Enterprises provides that company managers may be disqualified from being appointed as directors for the failure to comply with certain legal requirements. The relevant obligations are (a) timely filing for insolvency; (b) transferring the company's assets and all relevant documents relating to the company to the insolvency administrator once the insolvency proceedings have been opened; (c) providing all information necessary for the insolvency proceedings to the insolvency administrator. Furthermore, any obstruction of the insolvency proceedings can also lead to a disqualification order. In these cases, the court may restrict the right of such individual to hold the position as company manager or be appointed a member of the board of directorsof any company for three to five years.

Article 682 of the Penal Code provides that the court is also entitled to issue a disqualification order in relation to the director's right to work in certain professions or engage in certain activities, provided that the director commits a criminal act in his or her professional or trade activities. In deciding on this sanction, the court has to take into account the nature of the committed criminal act. The disqualification under this provision can be order by the court for a time period of one up to to five years.

As mentioned above, Article 2.131 of the Civil Code provides that in the event that the expert's report points out that company's activities are inappropriate, the court may temporarily suspend the powers of the members of the managing bodies of that company or exclude a person from the managing body of the legal entity.

In all cases the decision to disqualify the director of the company may be taken only by the authorised court. However, the disqualification of the directors is a relatively new legal development, and has not yet been used extensively in practice.[87]

[87] Article 682 of the Penal Code came into force on 5 June 2011, while Article 10 (14) of the Law on Bankruptcy of Enterprises came into force on 1 March 2012.

7 CONFLICT OF LAWS

7.1 Classification under Lithuania's private international law

7.1.1 Company law

Under Lithuanian law the incorporation doctrine is applied for identifying the law applicable to a company.[88] According to Article 1.20 of the Civil Code, the jurisdiction of incorporation determines the following issues:

- the legal form and status of a legal entity person or any other organization;
- incorporation, reorganization and liquidation of a legal entity or any other organization;
- the name of a legal entity or any other organization;
- the system and competence of the bodies of a legal entity or any other organization;
- civil liability of a legal entity or any other organization;
- the power to represent a legal entity or any other organization;
- legal effects of the violation of laws or incorporation documents.

7.1.2 Tort law

The law applicable to a non-contractual obligation arising out of a tort shall be the law of the country in which the damage occurs irrespective of the country in which the event giving rise to the damage occurred and irrespective of the country or countries in which the indirect consequences of that event occur.[89] Although director's liability is based on tort law principles, the main liability rules are part of Lithuanian company law. As such, they generally apply to companies incorporated in Lithuania.

7.1.3 Special duties in the vicinity of insolvency

According to Article 4 (1) of the EU Insolvency Regulation,[90] the law applicable to insolvency proceedings is the law of the Member State within the territory of which such proceedings are opened. Article 3 (1) of the EU Insolvency Regulation provides that the courts of the Member State within the territory of which the centre of a debtor's main interests is situated shall have jurisdiction to open insolvency proceedings. In the case of a company or legal person, the place of the registered office shall be presumed to be the centre of its main interests in the absence of proof to the contrary. The duty to file for insolvency, as described above, is a rule of insolvency law, and will thus apply to companies having the centre of their main interest in Lithuania.

[88] Article 1.19 of the Civil Code
[89] Article 4 (1) of Regulation (EC) No 864/2007 of 11 July 2007 on the law applicable to non-contractual obligations (Rome II)
[90] Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, OJ L 160/1, 30.6.2000; "EU Insolvency Regulation".

7.2 Application of the relevant private international law rule

The law applicable to a non-contractual obligation arising out of a tort shall be the law of the country in which the damage occurs irrespective of the country in which the event giving rise to the damage occurred and irrespective of the country or countries in which the indirect consequences of that event occur.[91]

[91] Article 4 (1) of Regulation (EC) No 864/2007 of 11 July 2007 on the law applicable to non-contractual obligations (Rome II)

LSE Enterprise

DIRECTORS' DUTIES AND LIABILITY IN LUXEMBOURG

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Contents

1 INTRODUCTION

1.1 Legislative approach: statute/case law

The Luxembourg legal system is part of the Roman-civil law family and thus characterised by a statute-based legislative approach. The first rules concerning the regulation of companies were contained in the Napoleonic Codes, more precisely in the *Code civil* (hereafter the "Civil Code") of 1804 and the *Code de commerce* (hereafter the "Commercial Code") of 1807. As in other jurisdictions, the rules were however considered to be insufficient and incomplete to deal with the development of the industrial revolution, with the result that the Luxembourg legislature adopted the *Loi concernant les sociétés commerciales* of 10 August 1915 (hereafter the "Companies Act") as a coherent ensemble regulating all the different types of commercial companies. In this context, it is important to note that the relevant rules concerning civil companies are still contained in the Civil Code, more precisely in articles 1832 to 1873. These provisions also continue to be referred to as the source of the general principles that apply to all companies regardless of their civil or commercial qualification.[1] Finally, the Commercial Code comprises the Luxembourg insolvency rules (articles 437 to 614), together with a Great-Ducal decree on controlled management (*gestion controlée*) of 24 May 1935.

The rules on directors' duties and liability flow from common law principles (Art. 1382 et seq. of the Civil Code) and specific provisions of the Companies Act. The Companies Act distinguishes liability for breach of the duty of care[2] and liability for breach of the company's statutes or violation of the Companies Act.[3]

The Luxembourg Companies Act is strongly inspired by the Belgian legislation. The original 1915 Companies Act was drafted by a Professor of Louvain, Jean Corbiau, and was heavily influenced by the 1873 Belgian Companies Act. This explains why practicing lawyers often turn towards the Belgian doctrine and jurisprudence when it comes to solving a legal issue under Luxembourg law.[4]

Courts' decisions in the area of directors' liability are rare. There is also not much academic literature in Luxembourg on directors' liability or company law in general. Academic literature is limited to two general books on company law, some specialised books on certain company law issues, and some articles.

[1] Art. 1, Par. 2 of the Companies Act.
[2] Art. 59, first paragraph, Loi du 10 août 1915 for the one-tier system; Art. 60bis-10, first paragraph – management board – and 60bis-18, first paragraph – supervisory board – Loi du 10 août 1915 for the two-tier system.
[3] (Art. 59, second paragraph, Loi du 10 août 1915 for the one-tier system; Art. 60bis-10, second paragraph – management board – and 60bis-18, second paragraph – supervisory board – Loi du 10 août 1915 for the two-tier system)
[4] A. STEICHEN, *Précis de droit des sociétés*, Luxembourg, Editions Saint Paul, 2011, pp. 26 and 28.

1.2 Corporate landscape in Luxembourg

There are six[5] different types of commercial companies that are exhaustively[6] enumerated under article 2 of the Companies Act. For each of these commercial forms, the Companies Act states specific rules, a great majority of which are shared among the different types of company. However, it is important to note that of these six forms, it is principally the *Société anonyme*, which may invite investment by the public and may be listed, that has been the most "successful" in Luxembourg. This is due to the possibility to raise considerable amounts of capital. Further, the *Société anonyme* is also characterised by the most complete and detailed legal framework.[7] This explains why family-owned small and medium size companies prefer to adopt the form of the *Société anonyme*, even if the legislator created the *Société à responsabilité limitée* (SARL) for these kind of enterprises.

Since the scope of this report is limited to public companies, the present paper will focus on the *Société anonyme* as well as the *Société en commandite par actions*, the latter's legal regime being virtually identical[8] to that of the *Société anonyme.* Consequently, the present paper will only explicitly mention the rules concerning the *Société en commandite par actions* that are different from the rules governing the *Société anonyme.*

The ownership structure of companies in Luxembourg is characterised by what is commonly called the *actionnariat de référence* (hereafter the "reference shareholder").[9] A reference shareholder controls the company whose shares he owns in the sense that he is able to determine who will be sitting among the members of the board of directors or the supervisory board as well as, when the company's statutes so provide, the management board and hence directing the corporate strategy. This considerably reduces the scope for agency problems.

1.3 The Board of a Luxembourg company

The rules concerning the management of a *Société anonyme* are contained in articles 50 to 66 of the Companies Act. The board structure in such a company can take two different forms: a one-tier system or a two-tier system.

There is a division of competences between, on the one hand, the *Conseil d'administration* (hereafter "the board of directors") responsible for setting the corporate strategy and the management of the company and, on the other hand, the *Assemblée générale des actionnaires* (hereafter the "general meeting of the shareholders") controlling the board's actions and activities as well as taking certain limited decisions specifically assigned to them by the law.[10] As a matter of principle, all powers reside with the board of directors of the company (articles 53 and 60bis-7) except for those powers that have been reserved by law to the general meeting of shareholders. Therefore, the board of directors enjoys a so-called "default" power which can be restricted by the general meeting only with internal effect.

[5] The société en nom collectif, the société en commandite simple, the société anonyme, the société en commandite par actions, the société à responsabilité limitée and the société coopérative.
[6] A. STEICHEN, *o. c.,* p. 490.
[7] A. STEICHEN, *o. c.*, p. 637.
[8] Article 103 of the Companies Act.
[9] A. STEICHEN, *o. c.*, p. 218.
[10] A. STEICHEN, *o. c.*, p. 706; M.-P. GILLEN-SNYERS, "Les banques luxembourgeoises et le corporate governance", *Droit bancaire et financier au Luxembourg,* v. III, Bruxelles, Larcier, 2004, p. 1121.

Large companies[11] however often name an *Administrateur-délégué* (hereafter the "Managing Director" who is part of the management board) or a *Directeur délégué à la gestion journalière / fondé de pouvoir* (hereafter the "Managing Officer" who is a third person) or adopt a *Comité de direction* (hereafter the "Management Committee"), to whom the board of directors delegates the competence for the day-to-day management of the company, in accordance with article 60 of the Companies Act.[12] They are the equivalent of the Chief Executive Officer (CEO). This results in a *de facto* dual structure,[13] operating a functional division between those who decide and those who control.

In 2006,[14] the legislator added, by inserting articles 60*bis*-1 to 60*bis*-16 into the Companies Act, the possibility for a *Société anonyme* to opt for a two-tier system consisting of a *Directoire* responsible for the company's management and a *Conseil de surveillance* in charge of the latter's supervision.[15] However, the one-tier system remains the dominant board structure in Luxembourg. The members of the *Directoire* are appointed by the *Conseil de surveillance*,[16] unless the articles of association provide for direct appointment by the shareholders. The structure of the *Conseil de surveillance* is analogous to that of the board of directors of a *Société anonyme*, i.e. its members are elected by the shareholders in general meeting.[17] The daily management of the company can also be entrusted to one or more delegates who may or may not be members of the management board (art. 60bis-8 Companies Act).

The role of the chairman of the board of directors is reduced to the tasks of convening, organising and presiding over the meetings of the board without being able to impose his views.[18] However, the CEO and the chairman of the board can be identical persons as there is no prohibition in the law against holding both functions. The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange (Corporate Governance Code),[19] however, favour such differentiation.[20]

While the *Société en commandite par actions* shares many common points with the *Société anonyme*, one of the major differences that exist between the two company types relates to the management mechanisms. The *Société en commandite par action* is managed by one or several *gérant(s)* (hereafter the "manager(s)") who must at the same time be *associé(s) commandité(s)*, in other words shareholder(s) whose responsibility is unlimited.[21] Such a manager is not elected by the general meeting of the shareholders, but must be appointed by the company's articles of association.

[11] For example, Arcelor Mittal.
[12] M.-P. GILLEN-SNYERS, *o. c.*, p. 1128.
[13] P.-H. CONAC, "Les organes de la société anonyme (SA) en droit luxembourgeois", *Le nouveau droit luxembourgeois des sociétés*, Bruxelles, Larcier, 2008, p. 51.
[14] Law of 25 August 2006, Mém. A, n° 152, August 31, 2006, 2684.
[15] J.-P. WINANDY, *Manuel de droit des sociéts*, Luxembourg, Legitech, 2008, pp. 541 and f.
[16] A. STEICHEN, *o. c.*, p. 761.
[17] A. STEICHEN, *o. c.*, p. 767.
[18] A. STEICHEN, *o. c.*, p. 217.
[19] *Ten Principles of Corporate Governance of the Luxembourg Stock Exchange,* October 2009, available at www.bourse.lu, p. 14. These principles are generally considered to be *soft law* (J.-P. WINANDY, *o. c.,* p. 414).
[20] Recommendation 1.3. The executive management of the company should be entrusted to a management body, headed by an individual other than the chairman of the board. The board should make a clear distinction between the duties and responsibilities of its chairman and of the chief executive officer and set this out in writing.
[21] Article 107 of the Companies Act; J.-P. WINANDY, *o. c.*, p. 602; A. STEICHEN, *o. c.*, pp.842; J. R. NLEND, *La responsabilité des dirigeants de sociétés en droit luxembourgeois*, Luxembourg, Euroconsult S.C.P., 1997, p. 27.

2 THE CONCEPT OF 'COMPANY DIRECTOR' IN LUXEMBOURG

2.1 De jure directors

2.1.1 Requirements to become a *de jure* director

The general meeting of shareholders is exclusively competent for the nomination of *de jure* directors. Typically the decision to nominate a *de jure* director takes the form of a direct election by the general meeting and requires a majority of votes.[22] Exceptionally, the directors can also be designated in the articles of association provided that this kind of nomination takes place when the company is first constituted.[23]

2.1.2 Who can become *de jure* director?

Under Luxembourg law, a company is in general free to choose its directors, since the law does not require any a *priori* condition to be fulfilled. The director is neither supposed to be particularly qualified, nor is he requested to prove his management skills. His place of residence is irrelevant and it is not necessary that he is a shareholder (apart from the *Société en commandite par actions*, where the manager must be an *associé commandité* as already mentioned *supra)*.[24]

The position of a director can be held either by a natural person or by another corporate entity. In the case that the director is a natural person, it is necessary that such a person enjoys full judicial capacity.[25] Further, directors that have contributed grossly negligently (i.e. by committing a characterised and serious offence) to the bankruptcy of a company, and who consequently have been prohibited by the commercial court from exercising the function of a director, are barred from being nominated to such a position.[26]

Since 2006, the legal person who is appointed as a director must have a permanent representative.[27] On his/her appointment, he/she must designate such permanent representative, who shall be subject to the same conditions and obligations and who shall incur the same civil and penal liabilities as a director in his own name, without prejudice to the joint liability of the legal person they represent.

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[22] A. STEICHEN, *o. c.*. p. 197.
[23] Article 51 of the Companies Act.
[24] A. STEICHEN, *o. c.*, pp. 196 and 710 to 711.
[25] A. STEICHEN, *o. c.*, p. 195.
[26] A. STEICHEN, *ibid.*
[27] Articles 51*bis* and 60*bis* of the Companies Act; J.-P. WINANDY, *o. c.*, p. 511; A. STEICHEN, *o. c.*, pp.195 and 196. This requirement was inspired by a similar requirement in French company law (Art. L. 225-20 Commercial code) and in Belgian company law (Art. 61 of the Companies Code).

2.2 De facto directors

In addition to the *de jure* directors, Luxembourg law also recognises *de facto* directors who are not officially provided with a corporate mandate, but who in fact and in reality manage the company by carrying out all of the functions that are supposed to be performed by a regular director.[28] A person is considered to be a *de facto* director if he/she appropriates the powers of the *de jure* directors or substitutes himself/herself for the corporate organs by taking decisions capable of binding the company.[29] Such an intrusion is considered to be unlawful and exposes the respective *de facto* director to both civil and criminal sanctions.[30]

The elements leading to the identification of a *de facto* director are determined by the courts through a facts-based analysis. Two criteria must be fulfilled cumulatively in order to qualify as a *de facto* director: a positive activity consisting in directing the company, hence exceeding the simple function of advising, and an activity that is carried out independently and freely.[31]

2.3 Shadow director

The concept of “shadow director” is not explicitly referred to under Luxembourg law, neither by the legal texts, nor by the courts. However, it is equivalent to a *de facto* director.

[28] A. STEICHEN, *ibid.*; Lux., 1ier octobre 1997, R. n°s 12583, 12771, 12859, 12896 and 20243, *Recueil de législation – Sociétés et Associations*, Luxembourg, Service Central de législation, 2010, p. 202, n° 17; J. R. NLEND, *o. c.* p. 36; J.-P. WINANDY, *o. c.*, p. 557.
[29] G. RAVARANI, *La responsabilité civile des personnes morales et physiques,* Luxembourg, Pasicrisie luxembourgeoise, 2006, p. 456.
[30] See for example articles 444-1, 495 and 495-1 of the Commercial Code exposing the legal consequences for a *de facto* director who committed characterized and serious offences that contributed to the bankruptcy of a company. These provisions explicitly refer to the concept of “*de facto* director”.
[31] A. STEICHEN, *ibid.*

3 SCOPE OF DIRECTOR'S DUTIES UNDER LUXEMBOURG LAW

3.1 Types of directors' duties and their sources

3.1.1 Duty of loyalty

The first of the duties to which directors are subject in Luxembourg can generally be described as the duty to execute their corporate mandate in the best interest of the company, i.e. to manage the company in the best possible manner to achieve the company's purpose, as defined in its articles of association.[32] It is a duty that is implicitly but directly implied by their position as director. In addition, it is mentioned in Principle 2 of the Ten Principles of Corporate Governance of the Luxembourg Stock Exchange.[33] Indeed, since a company can never act by itself but is necessarily compelled to act through its "organs" (i.e. the directors), and since a company is always constituted for a specific purpose, stated in its objects clause, the principal task of the directors is to manage and direct the company in a way to realise the corporate objects while acting in the best interest of the company as a whole.[34] Further, under Luxembourg law, directors are considered to be agents of the company and hence subject to the general rules that govern all contracts in general and all agency contracts in particular.[35] This implies that directors, like all contractual parties, have to be loyal to their counter-party (i.e. the company) when implementing the contract they have concluded.

This type of duty is derived from two different texts of law. First, it is of general understanding that article 59 of the Companies Act,[36] which merely deals with the liability of directors, implicitly contains the obligation of the directors to act always (exclusively) in the best interest of the company.[37] In practice, the articles of association of the company provide that the directors must act at all times in the best interest of the company. Hence, if the directors do not act in the company's interest, they violate the articles of association in the sense of article 59 §2 of the Companies Act. Second, the duty

[32] G. RAVARANI, *o. c.*, p. 456; Lux., 28 février 1998, R. n° 2098/98 I, *unpublished*, quoted by G. RAVARANI, *o. c.*, p. 456, footnote n° 4; A. STEICHEN, *o. c.*, p. 219, n° 235; J.-P. WINANDY, *o. c.* p. 153.
[33] *Ten Principles of Corporate Governance of the Luxembourg Stock Exchange,* Octobre 2009, available at www.bourse.lu, p. 14. These principles are generally considered to be *soft law* (J.-P. WINANDY, *o. c.,* p. 414).
[34] A. STEICHEN, *o. c.*, p. 219, n° 237.
[35] P. THIELEN and J. DELVAUX, "La responsabilité civile des administrateurs de sociétés anonymes en droit luxembourgeois – situation actuelle et tendances futures", *Bull. Dr. et banque*, 1984 /4, p. 2; T.A. Lux., 23 avril 2004, R. n° 78675, *Recueil de législation – Sociétés et Associations*, Luxembourg, Service Central de législation, 2010, p. 200, n° 1.
[36] "The directors shall be liable to the company in accordance with general law for the execution of the mandate given to them and for any misconduct in the management of the company's affairs.
They shall be jointly and severally liable for both towards the company and any third party for damages resulting from a violation of this Act or the articles of association of the company. They shall be discharged from such liability in case of a violation to which they were not a party, provided no misconduct is attributable to them and provided they have reported such violation to the first general meeting held after they had acquired knowledge of the violation."
[37] A. STEICHEN, *o. c.,* pp. 841 to 844.

of loyalty is also derived from article 1134 §3 of the Civil Code,[38] which imposes a duty on parties to a contract to execute their obligations under the contract in good faith, meaning that any party to a contract must use its best endeavours to fulfil the contract. In other terms, a party to a contract must act loyally.[39] Acting in "good faith" is a general principle of law governing the execution of contracts. Moreover, good faith is "assumed", i.e. anyone who alleges that his counterparty acts in bad faith must prove it.[40]

Two points need to be noted concerning the duty of loyalty. First, article 59 of the Companies Act does not directly impose a duty on the directors as such, but it constitutes the legal basis to bring action against a director, either in contract (article 59 §1) or tort by third parties (article 59 §2).[41] Second, article 1134 §3 of the Civil Code does not grant a self-standing legal action, but is merely a rule of interpretation of existing contractual obligations and a rule of behaviour regarding their implementation.[42] Consequently, a company could not bring a claim against its directors based on article 1134 alone, but would need to combine the latter with article 1147 of the Civil Code, which is the legal basis for contractual liability.[43]

3.1.2 Duty of care

As already mentioned *supra*, directors are considered to be agents of the company and as such are subject to the general duties applicable to all agency contracts that are contained in articles 1984 ff. of the Civil Code. This implies that directors must perform their missions with diligence, seriousness, competence and good faith.[44] Indeed, since the relationship between a director and a company is contractual by nature,[45] it derives from such a categorisation that there is a duty on a director (as an agent) to act with the skill and care reasonably to be expected of an ordinary and reasonable director appointed to his role and placed in the same circumstances.[46] Moreover, as any individual, directors are also subject to the general duty of prudence and diligence imposed by Luxembourg law on any individual in any circumstances of his life (*obligation générale de prudence et de diligence*), which requires them to act always in a way not to cause any damage to third parties.[47]

Similarly to the duty of loyalty, the duty of care also derives from several texts of law. First, directors of companies are agents (*mandataires*) of the company. Therefore their duties derive from article 1991 of the Civil Code, which provides that an agent must act within the scope of his mandate. As a result, directors will be liable for any wrongful execution of their agency contract.[48] Second, the general provisions of articles 1382[49] and 1383[50] of the Civil Code are interpreted by case law as containing an underlying duty of prudence and diligence that is imposed on any individual in any circumstances of

[38] Article 1134 of the Civil Code: "Agreements lawfully entered into have the same binding effect as statutory law on those who made them.
Such agreements may be revoked only by mutual consent, or for causes authorized by law.
They must be implemented in good faith."
[39] Lux, 30 octobre 2002, *B.I. J.*, 2002, p. 36.
[40] P. VAN OMMESLAGHE, *Droit des obligations*, t. I, Bruxelles, Bruylant, 2010, pp. 168 ff.
[41] A. STEICHEN, *o. c.,* pp. 222 to 223.
[42] P. VAN OMMESLAGHE, *o. c.,*p. 175, n° 98.
[43] A. STEICHEN, *o. c.,* p. 222, n° 241.
[44] A. STEICHEN, *o. c.*, pp. 219 and 220.
[45] P. THIELEN and J. DELVAUX, *o. c.*, p. 3, n° 5.4.
[46] Sommaires de jurisprudence, *Pasicrisie*, n° 29, p. 111, n°s 209 and 210; A. STEICHEN, *o. c.*, p. 225.
[47] *O. c.*, p. 111, n° 208.
[48] Ibid.
[49] "Any act whatever of man which causes damage to another, obliges the one by whose fault it occurred to compensate it."
[50] "Everyone is liable for the damage caused not only by their intentional act, but also by their negligent conduct or imprudence."

his life, making him liable to all those to whom he caused damage.[51] Third, article 59 of the Companies Act is interpreted by case law in the sense that a director (as agent) is bound to act with the skill and care reasonably to be expected of an ordinary and reasonable director appointed to his role and placed in the same circumstances. Indeed, the jurisprudence holds that article 59 of the Companies Act is merely an application of articles 1382 and 1383 of the Civil Code, except for the "aggravated" liability of article 59 §2, which will be discussed *infra* in section 3.[52]

3.1.3 Duty of confidentiality

The duty of confidentiality is explicitly provided for under article 66 of the Companies Act.[53]

The members of the board (as well as any person invited to attend the meetings of the board) have a duty not to divulge any information which they have concerning the company and which could be prejudicial to the company's interests.[54] As this duty is applicable in case the disclosure might be prejudicial to the company's interests, one does not have to wait until the prejudice is realised, the mere risk of a prejudice being sufficient. The Companies Act contains an exception to the duty of confidentiality when legal provisions require or allow such disclosure, as well as when the disclosure is of public interest. The duty of confidentiality continues to apply even after the directors have ceased to exercise their function(s) in the company.[55]

3.1.4 Duty of information

Since the board is generally accountable to the shareholders for the proper management of the company, the Companies Act sets out a large number of specific information duties.[56] These comprise *inter alia* the duties exposed in articles 72 to 75 of the Companies Act: make an inventory, draw up the balance sheet, the profit and loss accounts and the management report and present these documents to the general meeting of the shareholders for approval. Other duties include the obligation to convene the annual general meeting of shareholders (articles 100 and 163 n°2 of the Companies Act).[57]

The multiple duties of information imposed on directors due to their accountability towards the shareholders in general meeting are enumerated in numerous different parts of the Companies Act, the most common being articles 72 to 75 relating to the inventory and the annual accounts, or articles 100 and 163 relating to the duty to convene the annual general meeting of the shareholders.

3.1.5 Duty to declare bankruptcy

A specific duty of the directors of a company consists in the filing with the competent First Degree Commercial Court of a declaration that the company is insolvent (*faillite*) within one month of the date

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[51] Sommaires de jurisprudence, *Pasicrisie*, n° 29, p. 111, n° 210.
[52] *O. c.*, p. 111, n° 208.
[53] "The directors, members of the "directoire" and the "comité de surveillance", as well as any other person invited to attend the meetings of the board, must not divulge, even after they have ceased their functions in the company, any information which they have concerning the Company and which could be prejudicial to the company's interests, except for the cases where legal provisions require or allow such disclosure, or when the disclosure is of public interest".
[54] Article 66 of the Companies Act; A. STEICHEN, *o. c.*, pp. 220 and 221.
[55] Article 66 of the Companies Act.
[56] A. STEICHEN, *o. c.*, pp. 220 and 221.
[57] For other specific duties see A. STEICHEN, *o. c.,* pp. 720 to 725.

on which the company ceased to pay its debts. The duty to file with the First Degree Commercial Court a declaration that the company is insolvent within a month of the date on which the company ceased to pay its debts is a duty that is explicitly provided for in article 440 §1 of the Commercial Code.[58]

According to the Commercial Code (article 439), a company is considered being insolvent under Luxembourg law when (1) it actually ceases to pay its debts (*cessation de payements*) and (2) when its credits are exhausted and no new credits are granted (*ébranlement de crédit*). These conditions are cumulative.[59]

3.1.6 No conflict duty

Conflict of interest issues are specifically addressed under Luxembourg law. It is provided that any director having an interest conflicting with that of the company in a transaction submitted for approval to the board is obliged to inform the board of said conflict. A record of his statement shall be included in the minutes of the board meeting and he may not take part in the related deliberations. Any such conflict of interest must be reported to the next general meeting of shareholders prior to taking any resolution on any other item.[60]

It is important to note that directors do not need to comply with these particular duties when the relevant decisions fall into the scope of the company's current operations and are taken under normal conditions.[61]

The duties that arise when a director is in a situation where his interests may conflict with those of the company, as well as the adjacent exception, are explicitly stated in article 57 of the Companies Act.[62] Since article 57 of the Companies Act has a very wide scope, corporate opportunities could be covered by this article. However, there is no case law in Luxembourg on this point and it is doubtful that, given the general liberal approach embedded in Luxembourg company law, a director would be found liable for such acts.

Principle 5 of the Ten Principles of Corporate Governance of the Luxembourg Stock Exchange provides that directors should take care to avoid any direct or indirect conflict of interest with the company or any subsidiary controlled by the company.[63]

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[58] "Any tradesman, as well as any commercial company which has ceased to pay its debts must, within a month, file a declaration with the Commercial Court of the location of its corporate headquarters stating that the company has ceased to pay its debts."

[59] J.-P. WINANDY, *o. c.,* pp. 841 to 844.

[60] A. STEICHEN, *o. c.,* pp. 743 to 747; J.-P. WINANDY, *o. c.,* pp. 530 to 531.

[61] Article 57 of the Companies Act.

[62] "Any director having an interest, conflicting with that of the company, in a transaction submitted for approval to the board, is obliged to inform the board of said conflict. A record of his statement shall be included in the minutes of the board meeting and he may not take part in the related deliberations.
Any such conflict of interest must be reported to the next general meeting of shareholders prior to taking any resolution on any other item.
In the event that the company is governed by a sole director, it is only required to report the transaction concluded between the company and the director having an interest conflicting with that of the company in a transcript.
The provisions of the preceding paragraphs are not applicable in the event that the decisions of the board or of the director relate to the current operations of the company and have been taken under normal conditions."

[63] *Ten Principles of Corporate Governance of the Luxembourg Stock Exchange,* October 2009, available at www.bourse.lu, p. 20.

As a result, it can be observed that directors' duties under Luxembourg law are defined in multiple ways:

First, they arise under statute, under case law and as a general principle. What is more, the same duty sometimes exists at the same time under all or several of these three different forms. Second, the duties arise under company law, tort law, contract law and insolvency law.

In this context, one should also note that in practice, the articles of association frequently contain additional duties, e.g. a duty to avoid functional conflicts of interest or a duty to retire once a certain age is reached.

3.1.7 Relationship between the different duties (cumulative/alternative)

Even if there is neither an explicit statutory provision, nor any particular case law concerning the question, it follows from the general statutory system of directors' duties under Luxembourg law that these duties are cumulative and not alternative. Further, there are no priorities between them.

3.2 To whom are the duties owed?

Most of the duties described above are owed to the company with which the directors are traditionally considered to be in a contractual relationship, but some are also owed to third parties.[64]

The duties of loyalty, care, confidentiality, information and to avoid conflicts of interest are owed to the company, represented by one of its organs (the board of directors or the general meeting of shareholders).

The concept of "interest of the company" or "corporate interest" is defined neither in the Companies Act, nor in the Civil or Commercial Code. However, it is mentioned under article 1859 of the Civil Code which requires the associates not to use the company's assets in a way that would be contrary to the interests of the company. It is, under Luxembourg law, a fluctuating and case-law defined concept that does not correlate with the interests of the shareholders.[65] Indeed, the corporate interest is considered to be the interest of the corporate entity, a body different from the individual shareholders. This appears implicitly from the Ten Principles of Corporate Governance of the Luxembourg Stock Exchange, since Principle 2 (Duties of the board) states that director "will act in the best interests of the company and will protect the general interests of the shareholders by ensuring the sustainable development of the company". This implies that there is a distinction between the "interests of the company" and the "general interests of the shareholders", since the two concepts are distinguished in the same sentence. In addition, the 2009 modification to the TPCG provides that "[w]hen determining the company's values, the board should take into consideration all the aspects of the corporate responsibility of the company" (guideline to recommendation 2.3).

[64] A. STEICHEN, *o. c.,* p. 222, n° 241.
[65] See. I. Corbisier, La société: contrat ou institution?, éd. Larcier, 2011, spéc. n°68, p 475.

Since the corporate interest cannot be reduced either to the interests of each individual shareholder, or the particular interests of a group of majority shareholders, it must be appreciated in an abstract way. The corporate interest is first and foremost based on the quest for profit maximisation and the distribution of those profits between the shareholders. But apart from this financial dimension, it also includes a larger dimension which is that of a collective interest that is pursued inside the company.[66]

As a result, the concept of the corporate interest exceeds the mere summation of the shareholders' individual interests and must be considered as the interest of the company as an institution itself.[67] What concretely this interest is will depend on the nature of the corporate activities so that for some types of company the shareholder value theory might be adequate, whereas for other types the stakeholder theory will be more appropriate.[68]

In this context, it is important to distinguish the interests of the company itself from the interests of the group of companies of which it may be a part. Even if there is no case-law definition of the interests of the group, scholars strongly recommend that directors do not try to entrench themselves behind the concept of the interest of the group to justify transactions that are disproportionate for their own company.[69] Indeed, in spite of the affiliation of a company to a group, it is necessary to maintain a certain contractual balance in intragroup transactions. The only difference that the membership in a group of companies entails for its individual members is that the interest of the group as a whole needs to be appreciated as an element of the corporate interest, without however resulting in a situation where the interest of the group completely absorbs the corporate interest of its individual members. The test will be to determine whether any "favour" or "sacrifice" that the individual member company has to make is compensated by a certain "return".[70]

Luxembourg scholars are supporting the French Rozenblum approach,[71] which is also recognized by Belgium courts. This doctrine admits a "group defence" under certain conditions. First, there must be a group characterised by capital links between the companies. Second, there must be strong, effective business integration among the companies within the group. Third, the financial support from one company to another company must have an economic quid pro quo and may not break the balance of mutual commitments between the concerned companies. Fourth, the support from the company must not exceed its possibilities. In other words, it should not create a risk of bankruptcy for the company.

3.3 The director as a shareholder

First of all, it is important to note that in a *Société anonyme* it is no longer required that a director must at the same time also be a shareholder (as was the case under the old system of the "*actions de garantie*").[72] This obligation, however, still exists in the *Société en commandite par actions* where the manager must be an *associé commandité*, i.e. a shareholder. In any case, a director who is at the same time a shareholder is in exactly the same situation as an ordinary shareholder who does not

[66] A. STEICHEN, *o. c.,* p. 163.
[67] J.-P. WINANDY, *o. c.,* pp. 152 to 153.
[68] A. STEICHEN, *o. c.,* p. 162
[69] A. STEICHEN, *o. c.,* p. 436.
[70] A. STEICHEN, *o. c.,* pp. 162 to 163; J.-P. WINANDY, *o. c.,* pp. 155 to 156 and p. 771.
[71] See Trib. Corr. Paris, 16 May 1974, Soc. Saint-Frères, D. 1975, p. 37, Rev. Sociétés 1975, p. 657, n. B. Oppetit, JCP éd. E. 1075, II-11816, p; 381; Court of cassation, Criminal Chamber, 4 February 1985, Rozenblum and Allouche, D.1985, p. 478, n. D. Ohl, I-639, JCP 1986, II-20585, n. W. Jeandidier, Rev. Sociétés 1985, p. 648, n. B. Bouloc.
[72] J.-P. WINANDY, *o. c.,* p. 534.

hold a particular function in the company.[73] As a result, a director who acts in his function as a shareholder is subject to all ordinary duties that apply to shareholders in general when exercising their rights, but he is in such a situation not subject to the above described duties that apply specifically to directors.

3.4 The time span of the duties

The beginning and the end of the different duties that apply to directors differ with the nature of these duties.

The duties that apply specifically to directors by reason of their function as part of the managing organ of a company evidently apply only once their nomination has become effective. This is an application of the general principle of contract law "*Principe de la convention-loi*" or *"Pacta sunt servanda"*, as stated in article 1134 of the Civil Code.

On the other hand, the general duty of prudence and diligence imposed on any individual in any circumstance of his life clearly applies to a director even before his nomination has become effective, given that it is a duty that is perfectly independent of his quality as a director. The only condition in this respect derives from the general principles of tort law which require for any person, in order to be held responsible for his acts, to be 'capable', i.e. not to be in one of the legal cases of incapacity (minors, guardianship, etc.).[74]

3.5 Application of duties to de facto directors and shadow directors

According to Luxembourg case law, a *de facto* director is subject to exactly the same duties and liabilities as a *de jure* director, given that he directly influences the corporate strategy and acts as if he would represent the company.[75]

Since a "shadow director" is not a concept legally recognised under Luxembourg law, such a person can only be subject to articles 1382 and 1383 of the Civil Code, which are general provisions from which case law has inferred an underlying duty of prudence and diligence imposed on any individual in any circumstance of his life (*obligation générale de prudence et de diligence)*. The precise content of this duty will be addressed *infra* in part 3 of the report, given that it is part of the duties that apply to *de jure* directors as well.

[73] J.-P. WINANDY, *ibid.*
[74] G. RAVARANI, *La responsabilité civile des personnes morales et physiques,* Luxembourg, Pasicrisie luxembourgeoise, 2000, pp. 33 ff.
[75] Lux., 1ier octobre 1997, *aforementioned*; A. STEICHEN, *o. c.*, p. 197; J.-P. WINANDY, *ibid.*

4 LIABILITY FOR BREACH OF DUTY

4.1 Civil liability regime in respect of all duties

Under Luxembourg law, the main legal basis to bring liability against a director is article 59 of the Companies Act. Indeed, this provision constitutes the legal basis for breaches of *all* of the duties described *supra* in section 3.

In this context, it is important to note that senior executives,[76] *fondés de pouvoir* or other officers who may have an employment agreement, appointed to carry out the daily management of the company, are not subject to article 59 of the Companies Act. Instead, they act as agents (*mandataires*) of the board of directors and their liability is determined by the general rules governing agency agreements (articles 1984 ff. of the Civil Code), which provide that the agent incurs a contractual liability towards the principal if he does not carry out the mandate conferred on him or commits errors in its performance.[77]

Also, directors may be liable on the basis of common tort law towards third parties (Art. 1382 et seq. of the Civil Code). They are liable for the damage resulting from violations of the Companies Act or the articles of association. They can also be liable for management mistakes towards third parties. In this case, the academic literature supports the French approach which limits director's liability towards third parties to cases of severable fault from the manager's functions.

Article 59 of the Companies Act contains two levels of liability: a general level of liability and an enhanced level of liability. Both types of liabilities are set out below.

4.1.1 General liability (article 59§1)

Article 59 §1 deals with "common law" individual and contractual liability (*responsabilité contractuelle*) of the directors towards the company. Specifically, article 59 §1 provides that: "The directors shall be liable to the company in accordance with general law for the execution of the mandate given to them and for any misconduct in the management of the company's affairs". A similar provision exists for the two-tier system (articles 60bis-10 §1 for the management board and 60bis-16 §1 for the supervisory board).

The directors are liable if they have committed a contractual breach (*faute contractuelle*), i.e. if they have violated an obligation contained in their contract. This type of liability is typically called "liability for management errors", i.e. for wrongful acts committed during the performance of the directors'

[76] Subject to article 60, par. 5 of the Companies Act.
[77] Avis de l'ABBL relatif au projet de loi n° 5730 portant modernisation de la loi du 10 août 1915 concernant les sociétés commerciales, 16 October 2008, www.abbl.lu.

mandate (*mandat*) granted to them by the company (*responsabilité pour faute de gestion*).[78] In this context, article 59 is considered to be an application of articles 1991 ff. of the Civil Code regulating the general liability of any person bound by an agency contract.[79]

Three cumulative conditions need to be fulfilled in order for liability of the directors for management errors to exist: a fault, i.e. a "management error", a loss or a prejudice and causation.[80] The burden of proof is borne by the company, represented by the general meeting of shareholders.[81] In this context, causation is typically the element which is the most difficult to prove.[82]

Causation means that the fault must be the *conditio sine qua non* of the damage: there is causation if, without the fault, the damage would not have arisen. In this context, Luxembourg courts favour the *"théorie de la causalité adéquate"*, which is more favourable to the defendant. It means that the judge has to assess for each event preceding the loss whether such event is a direct and immediate cause of the loss.[83]

Concerning the nature of the fault, there are numerous examples of management errors that have been sanctioned by case law.[84] No difference is made between acts and omissions.[85]

The standard or criteria which is used by Luxembourg courts in order to characterise an act or omission as a management error is whether such act or omission would have been made by a director of average and reasonable prudence and competence acting under the same circumstances or facts, called *"le critère du bon père de famille"*, i.e. the standard of the good family father.[86] This facts-based definition gives the courts great flexibility and freedom in order to judge the merits of each case, without providing a more specific general guideline, other than the consideration that the decision must not be unreasonable.

Following the Civil code rules on the liability of agents, Luxembourg Courts apply a slightly different standard depending on whether the director is paid for his services or does not receive compensation.[87]

The management error of a director who receives remuneration is determined *in abstracto*, i.e. in comparison to the standard attitude of a diligent and careful director acting in such a situation, without taking into consideration the personal skills or deficiencies of the tortfeasor.[88] The management error

[78] J.-P. WINANDY, *o. c.,* pp. 534 and 535.
[79] G. RAVARANI, *ibid.*
[80] Sommaires de juriprudence, *Pasicrisie*, n° 29, p. 112, n° 213.
[81] G. RAVARANI, *o. c.*, p. 458, n° 563.
[82] Cour Lux., 27 Febuary 1973, *Pas. 23*, p. 481; THIELEN and J. DELVAUX, *o. c.*, p. 9, n° 7.8.
[83] G. RAVARANI, *La responsabilité civile des personnes morales et physiques,* Luxembourg, Pasicrisie luxembourgeoise, 2000, pp. 457 and 458.
[84] T.A.Lux., 29 March 1985, R. n°s 35483, 35484, 35582, *unpublished*, quoted in *Recueil de législation – Sociétés et Associations*, Luxembourg, Service Central de législation, 2010, p. 200, n° 3; J.-P. WINANDY, *o. c.,* pp. 554 and 555.
[85] P. THIELEN and J. DELVAUX, *o. c.*, p. 6.
[86] P. THIELEN and J. DELVAUX, *o. c.*, p. 6; J.-P. WINANDY, *o. c.,* p. 555; A. STEICHEN, *o. c.,* p. 225; G. RAVARANI, *o. c.*,p. 456, n° 562; T. A. Lux., 3 juillet 1987, R. n° 36875, *unpublished*, quoted in *Recueil de législation – Sociétés et Associations*, Luxembourg, Service Central de législation, 2010, p. 200, n° 4; Cour Lux., 27 février 1973, *Pas. 23*, p. 481.
[87] Art. 1992 Par. 2 of the Civil Code.
[88] Cour Lux., 27 février 1973, *Pas. 23*, p. 481; T. A. Lux., 15 mars 2001, R. n° 48959, *unpublished*, quoted in *Recueil de législation – Sociétés et Associations*, Luxembourg, Service Central de législation, 2010, p. 201, n° 10; J.-P. WINANDY, *o. c.,* p. 555; A. STEICHEN, *o. c.*,p. 226.

of a director who receives no financial consideration is appreciated *in concreto*, i.e. in comparison to the abilities of this particular director.[89] This is, however, rarely the case in practice.

As a result, a "slight" fault is sufficient to engage a director's liability for management errors so that scholars conclude that contractual liability exists in case of a *culpa levis in abstracto* with regard to the assumed behaviour of a good caretaker.[90]

When assessing the legality of the actions of management organs Luxembourg courts conduct a "marginal" and "a priori" appreciation:

A certain error margin is admitted. Luxembourg courts take into account the fact that directors have a certain margin of appreciation (*marge d'appréciation*) in managing the company's business, meaning that they are only subject to an "*obligation de moyens*", i.e. a duty to use their best endeavours without being compelled to achieve a concrete result.[91] Case law grants directors a certain "right to commit management errors" as long as they stay within the limits of their margin of appreciation so that they benefit from a sort of "business judgement rule".[92] For example, courts have held that the fact of not filing with the Commercial Court a declaration that the company is insolvent within a month of the date on which the company ceased to pay its debts is a breach exceeding the admissible margin of appreciation within which a director is allowed to commit errors.[93]

Further, courts will need to take into account the circumstances that existed at the time when the directors' decision was taken (*appreciation a priori)* as well as the information which was known or should have been known by the director when he made the challenged decision.[94] The judge has to place himself or herself in the position of the director at the time when the decision was taken to decide on its legality.

According to the Companies Act, the general meeting of shareholders may reduce the risk for a director of being sued by the company for management errors by granting discharge, called *"quitus"*, to the directors for the exercise of their mandate.[95]

The granting of discharge to the directors has two consequences:

Firstly, the directors are sheltered from the risk of facing liability claims towards the company on the basis of the decisions taken during the financial year of which the accounts have been approved.

Secondly, through the granting of the discharge, the company waives its right to act against the directors for decisions taken by them.[96]

[89] P. VAN OMMESLAGHE, *o. c.,* t. II, p. 1185.
[90] P. VAN OMMESLAGHE, *ibid*; A. STEICHEN, *o. c.,* p. 226.
[91] A. STEICHEN, *o. c.,*p. 226.
[92] A. STEICHEN, *o. c.,* p. 225; G. RAVARANI, *ibid.*; Cour Lux., 14 juillet 1998, quoted by G. RAVARANI, *o. c.,* p. 456, footnote n° 6.
[93] T. A. Lux., 13 February 2004, R. n° 75935, *unpublished*, quoted in *Recueil de législation – Sociétés et Associations*, Luxembourg, Service Central de législation, 2010, p. 201, n° 9.
[94] A. STEICHEN, *o. c.,* p. 226.
[95] Article 74 §2 of the Companies Act.
[96] A. STEICHEN, *o. c.,* p. 248, n° 272.

If the discharge has been validly given by the shareholders to the directors it may be held against the company even if the identity of the majority shareholders changes at a later date, as well as against any receiver in bankruptcy who may be appointed by a court.

However, a discharge is only considered to be validly given if:

- the annual accounts do not contain any omission or incorrect statement hiding the real financial situation of the company;
- the errors made by the directors are not intentional; and
- the decision has been validly taken by the annual shareholders' meeting following the approval of the annual accounts.[97]

In addition, it is important to note that the discharge only covers a director's liability towards the company, but never extends to the liability he might have against third parties.[98]

4.1.2 Enhanced liability (article 59§2)

An enhanced liability is provided for in article 59§2 which states that directors "shall be liable jointly and severally both towards the company and third parties for damages resulting from the violation of this law or the articles of the company". This liability is legal (*responsabilité légale*) and different from the contractual liability (*responsabilité contractuelle*) of the directors towards the company.[99] Third parties, and not only the company, are expressly allowed to file suit on such ground.

In this case, the directors' fault must necessarily consist in the breach of either the Companies Act or the company's articles of association. Examples of such breaches can be found in multiple court decisions.[100] The other general conditions for liability are the same (proof of loss and causation).

However, the "business judgement rule" that is granted to directors in relation with their management errors is not applicable when it comes to breaches of the Companies Act or the articles of association. Indeed, in the latter case, directors are subject to an *"obligation de résultat"*, meaning that the law expects them in any case to be compliant both with the Companies Act and with the articles of association of their company. Once a breach is established they are presumed to have committed a fault.[101]

The liability under §2 article 59 of the Companies Act is qualified as being "aggravated" in the sense that the liability is joint and several among all of the members of the board and all directors are presumed to be liable.[102] The effect of the joint and several liability is thus to overturn the burden of proof by compelling the directors to establish that they should not be held liable.[103]

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[97] A. STEICHEN, *o. c.,* pp. 249 and 250.
[98] A. STEICHEN, *o. c.,* p. 249, n° 273; G. RAVARANI, *o. c.,* p. 457, n° 562.
[99] P. THIELEN and J. DELVAUX, *o. c.*, p. 7, n° 7.1; J.-P. WINANDY, *o. c.,* p. 556.
[100] See T. A. Lux., 1ier juin 1966, R. n° 8835, quoted by G. RAVARANI, *o. c.,* p. 458, n° 564, and footnote n° 3; J.-P. WINANDY, *ibid.*
[101] A. STEICHEN, *o. c.,* p. 223; Sommaires de jurisprudence, *Pasicrisie*, n° 29, p. 112, n° 214.
[102] THIELEN and J. DELVAUX, *o. c.*, p. 9, n° 8.1.
[103] THIELEN and J. DELVAUX, *o. c.*, p. 8, n° 7.6.

As a result, joint and several liability can be avoided by any director only and to the extent that the director:

- was not personally involved in the breach;
- has not committed any wrongdoing (however, the mere absence at a meeting of the board where such wrongdoing was authorised will not remove liability if the absence was not justified or was the result of the indifference of the director towards the business of the company); and
- reports the breach at the next general meeting of shareholders.[104]

As in the case of article 59§1, if discharge is granted by the shareholders to the relevant director, the Company will have waived its right to bring an action against the director on the relevant matters. However, the discharge will not protect directors against liability claims introduced by third parties.[105]

4.2 Criminal Liability

In addition to the ordinary criminal liability that derives from the provisions of the Luxembourg Criminal Code (*Code pénal*), the Companies Act provides for specific criminal liability for directors for various specific offences of the Companies Act.[106] The most common are violations of the directors' duty of information (failure to submit or publish the annual accounts in due time, fraudulent misstatements of the balance sheet or the profit and loss accounts, etc.). Others are more specific, like the abuse of corporate assets (*abus de biens sociaux*),[107] consisting in the use, with bad faith, of either the assets or the credit of the company, or of the power which directors have or the votes they may cast, for a purpose which the directors knew was contrary to the interests of the company, for personal uses, or for the benefit or another company or undertaking in which they were directly interested.[108]

In accordance with the general principles of criminal law, directors will be presumed innocent until their guilt is proven beyond legitimate doubt.[109]

Since 2010, criminal sanctions may apply to a legal person.[110] Indeed, a legal person can be held criminally liable in Luxembourg if the violation has been committed in its name and to its advantage. However, since the criminal liability of the company itself does not exclude that of its directors, any criminal offence committed by a director can call for their criminal liability.[111]

[104] Article 59 §2 of the Companies Act; G. RAVARANI, *o. c.,* p. 459, n° 564; A. STEICHEN, *o. c.,* p. 224; J.-P. WINANDY *o. c.*, p. 556; T. A. Lux., 15 July 1993, *Bull. dr. et banque*, n° 21, p. 51, quoted in *Recueil de législation – Sociétés et Associations*, Luxembourg, Service Central de législation, 2010, p. 201, n° 14.
[105] THIELEN and J. DELVAUX, *o. c.*, p. 8, n° 7.3.
[106] See articles 162 ff. of the Companies Act.
[107] Article 171-1 of the Companies Act.
[108] A. STEICHEN, *o. c.,* pp. 242 to 245.
[109] A. STEICHEN, *o. c.,* p. 244, n° 266.
[110] Art. 34 of the Criminal code, as modified by Law on the criminal liability of legal persons dated 3 March 2010, Mémorial A, n°36, 11 March 2010, p. 614.
[111] A. STEICHEN, *o. c.,* pp. 241 and 242.

4.3 Exemptions and limitations

In addition to the above mentioned discharge that may be granted by the general meeting of shareholders to a director in order to shelter him against actions based on article 59 of the Companies Act, there are other ways that can be used by directors to reduce their liability risk.

The first possibility for directors to reduce their liability risk is to include a liability exemption clause in the articles of association of the company or in particular agreements signed between directors and their company.[112] According to Luxembourg case law, such an exemption clause must, in general, be accepted in accordance with the principles of civil law and in the limits fixed by the case law of the Luxembourg courts.[113]

Consequently, liability exemption clauses are valid in so far as they were voluntarily agreed without fraud, are not prohibited by a particular legal provision, legal principles, general interest or protection of certain creditors, and they are not in contradiction of the purpose of the agreement or empty the agreement of its substance.[114] Under such conditions, it seems generally accepted that liability exemption clauses for directors in the articles of association of a company or in particular agreements signed between the company and the director are valid.

Some scholars, however, argue that exemption clauses are only valid in general contract law, but not in company law. Their argument is that a director's liability towards his company is of public order, given that the legislator's wish was to counterbalance the directors' broad corporate powers. Hence, a clause that exempts a director from liability under company law would be contrary to the public order and thus invalid.[115] Belgian scholars defend the opposite position, and Belgian case law does not contradict them.[116]

Another possibility to reduce the risk of liability is the conclusion of an indemnity agreement (*lettre d'indemnité*). The indemnity agreement is a unilateral engagement taken by the company or the company's majority shareholder in which it is agreed that directors will be held harmless against the financial consequences of a judicial claim aiming to establish their personal liability.[117] In other words, the purpose of such an agreement is to indemnify the director against any damages, court expenses and expenses of legal counsel, for faults[118] committed during the exercise of their mandate as a director of the company.

The protection offered by an indemnity agreement is the same as the one granted under a D&O insurance policy, and such agreements are generally admitted under Luxembourg law, provided that they do not aim to cover criminal charges.[119]

[112] A. STEICHEN, *o. c.*, p. 246, n° 268.
[113] T. A. Lux., 23 May1969, *Pas. 21*, p. 385; Cour Lux, 13 December 1984, *Pas. 26*, p. 238.
[114] P. VAN OMMESLAGHE, *o. c.*, t. II, pp. 1655 ff.
[115] A. STEICHEN, *o. c.,* p. 246, n° 268; P. THIELEN and J. DELVAUX, *o. c.*, p. 4.
[116] P. VAN OMMESLAGHE, *o. c.*, t. II, pp. 1656, n° 1157.
[117] A. STEICHEN, *o. c.,* p. 247, n° 270.
[118] Except gross negligence and intentional conduct.
[119] Ibid.

Finally, it should be noted that article 157 of the Companies Act explicitly provides for a short period of limitations for all liability claims directed against a director. The possibility to introduce such a claim expires five years after the wrongful act has been committed. This five-year period of limitations applies to all claims for faults committed by a director during the exercise of his mandate, regardless of whether the claim is introduced by the company or third parties, and whether it is based on civil or criminal liability.[120]

However, since this is a provision that is favourable to directors, it is limited to *de jure* directors.[121]

There is no case law as to whether a director could be allowed ex ante by the shareholders to take a particular action and be absolved of liability. Belgian case law should be applied here and holds that such a vote would be effective.

4.4 Insurance against liability

Directors can protect themselves financially from claims introduced both by the company and third parties by taking out a D&O (Directors and Officers) civil liability insurance. Generally, such insurance agreements are signed by the company for all of their directors, but nothing prevents the director from signing such an agreement in his own name.[122]

Most of the civil risks generated by potential breaches of directors' duties (management errors, violations of the Companies Act or the articles of association) can be covered by such an insurance policy. However, the insurance policy cannot cover damages which are caused intentionally or by gross negligence.[123]

Further, the D&O insurance does not cover a director's criminal liability, given that the principle of the personal character of criminal sanctions makes it impossible for an insurance company to absorb any kind of criminal liability.[124]

4.5 Consequences of liability

4.5.1 Criminal liability

In respect of criminal liability, the sanctions always entail fines and/or imprisonment.

4.5.2 Civil liability

In respect of civil liability, the principle concerning civil damage indemnification under Luxembourg law is *"réparation en nature"*, i.e. indemnification in "nature". Since this is in most cases not possible,

[120] A. STEICHEN, *o. c.,* p. 250, n° 274; J.-P. WINANDY *o. c.*, p. 313.
[121] Ibid.
[122] A. STEICHEN, *o. c.,* p. 246, n° 269; R. NLEND, *o. c.,* p. 78, n° 78.
[123] A. STEICHEN, *ibid.*
[124] A. STEICHEN, *o. c.*, p. 247.

indemnification will typically be "by equivalent means", i.e. damages are granted to the party which has suffered a loss.[125]

According to article 1151 of the Civil Code (which is a provision specific to contract law but is considered to apply to all cases of civil liability, thus also to extra-contractual claims), damages should only be awarded in relation to losses that are an immediate and direct consequence of the fault. In a contractual claim, this means that only foreseeable losses will be indemnified, whereas such a limitation does not apply to extra-contractual claims.[126]

4.5.3 Consequences upon bankruptcy

Other, more particular sanctions also exist. These typically apply in the event of the company's bankruptcy and are stated in the Commercial Code. Three specific rules can be pointed out: prohibitions, extension of bankruptcy and liability for outstanding corporate debts.

a) Prohibition

According to article 444-1 of the Commercial Code, in the event that a director has contributed by a characterised and serious offence to the bankruptcy of the Company, the Commercial Court may declare that such person shall be prohibited from exercising directly or indirectly any commercial activity as well as the function of director, manager, statutory auditor, independent auditor or any function implying the power to bind the company.[127] For example, the fact of not filing with the Commercial Court a declaration that the company is insolvent within a month of the date on which the company ceased to pay its debts has been considered to amount to such a characterised and serious offence.[128]

b) Extension of bankruptcy

According to article 495 of the Commercial Code, any director of the company may be declared personally liable if:

- he has acted in his personal interest under the cover of the company;
- he has used the company's assets as if they were his own assets; or
- he has carried on, in his personal interest, a loss-making activity which could only lead the company into bankruptcy.

In the above cases, the liability of the director in relation to the bankruptcy includes, in addition to his personal liability, that of the company.[129] It should, however, be noted that the extension of bankruptcy is never automatic, but is always left to the determination of the court.[130]

[125] G. RAVARANI, *La responsabilité civile des personnes morales et physiques,* Luxembourg, Pasicrisie luxembourgeoise, 2000, pp. 514 to 516.
[126] *O. c.*, pp. 500 to 501.
[127] A. STEICHEN, *o. c.,* p. 238, n° 256.
[128] T. A. Lux., 13 Febuary 2004, R. n° 75935, *unpublished*, quoted in *Recueil de législation – Sociétés et Associations*, Luxembourg, Service Central de législation, 2010, p. 201, n° 9.
[129] A. STEICHEN, *o. c.,* pp. 237 to 238; P. THIELEN and J. DELVAUX, *o. c.*, p. 11, n° 9.4; T. A. Lux., 18 Febuary 1970, *Pas. 21*, p. 393; J.-P. WINANDY, *o. c.,* pp. 835 to 841.
[130] A. STEICHEN, *o. c.,* p. 237, n° 253.

c) Liability for outstanding corporate debts

According to article 495-1 of the Commercial Code, in the event of gross negligence committed by a director having contributed to the bankruptcy of the company, and in case the assets of the company do not allow full payment of all its creditors, the courts may decide that the directors shall be held liable, individually or jointly and severally, for the outstanding debts of the company.[131] The same liability shall apply in case one or several directors have misused their authority in order to continue a loss-making activity of the company for their own benefit, and without a reasonable chance to avoid bankruptcy.[132]

4.6 Duration of liability

Directors' duties do not necessarily cease once the directors quit their functions. Indeed, some of the duties still continue to apply afterwards.

First, the general duty of prudence and diligence imposed on any individual in any circumstance of his life logically continues to apply regardless of whether or not the director has ceased his corporate functions.

Second, as already mentioned above, it is explicitly stated in article 66 of the Companies Act that the duty of confidentiality also continues to apply once the director has lost his corporate status.

Moreover, according to Luxembourg case law, directors continue to be liable for all activity prior to their resignation.[133] Consequently, a resignation is ineffective as a means to escape liability. Further, directors can be held liable for damage that arises after their resignation, provided that the cause of the prejudice is rooted in facts committed during the exercise of their functions.[134] Similarly, directors can be held liable for acts committed prior to their entry into functions, provided that these acts produce effects that persist in time and that the directors have appropriated.[135]

Finally, directors must, even after their resignation, continue to take all necessary and required conservatory measures until their successors are validly appointed.

[131] A. STEICHEN, *o. c.,* pp. 238 to 241; P. THIELEN and J. DELVAUX, *o. c.*, p. 11, n° 9.3.
[132] T. A. Lux., 9 June 1989, R. n° 38792, *unpublished*, quoted in *Recueil de législation – Sociétés et Associations*, Luxembourg, Service Central de législation, 2010, p. 201, n° 8.
[133] A. STEICHEN, *o. c.,* p. 246.
[134] P. THIELEN and J. DELVAUX, *o. c.*, p. 8 *in fine*; G. RAVARANI, *La responsabilité civile des personnes morales et physiques,* Luxembourg, Pasicrisie luxembourgeoise, 2006, p. 459, n° 564.
[135] TA. Lux., 23 december 1987, R. n° 643/87, *unpublished*, quoted by Sommaires de juriprudence, *Pasicrisie*, n° 29, p. 115, n° 223.

5 DUTIES IN THE VICINITY OF INSOLVENCY

There are no provisions under Luxembourg law that would cause directors' duties to change in the vicinity of insolvency, nor are there any additional duties that arise. However, this does not mean that there are no particular rules that apply during that period.

5.1 The meaning of 'vicinity of insolvency'

"Vicinity of insolvency" is known under Luxembourg law as the "*periode suspecte*" which is the period of time extending from the day when the company has ceased to pay its debts (including the ten days preceding that date) to the day when it is declared bankrupt by the Commercial Court.[136]

5.2 Duty not to make 'abnormal' payments

The consequence is that articles 445 to 447 of the Commercial Code allow the receiver in bankruptcy to file a lawsuit in order to procure the nullity of all acts that have been concluded by the company, or more precisely by its directors, during that period and which can be qualified as "abnormal" in the sense that they were concluded in order to favour some creditors over others or to put certain valuable assets out of the creditors' reach.[137]

5.3 Duty to file for bankruptcy

The company has the duty to file a declaration that it is insolvent with the First Degree Commercial Court within a month of the date on which the company ceased to pay its debts (article 440 §1 of the Commercial Code).[138]

[136] Article 445 of the Commercial Code; J.-P. WINANDY, *o. c.,* p. 868.
[137] J. LEMMER, "La faillite en droit luxembourgeois", *Feuille de liaison de la Conférence Saint-Yves,* October 2004, n° 107, pp. 19 to 20.
[138] "Any tradesman, as well as any commercial company which has ceased to pay its debts must, within a month, file a declaration with the Commercial Court of the location of its corporate headquarters stating that the company has ceased to pay its debts."

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue?

6.1.1 The company as a plaintiff

As to who may bring the action based on article 59 of the Companies Act against the directors, it is again necessary to distinguish between §1 and §2 of the provision.

1) Since the directors' liability in relation to §1 of article 59 of the Companies Act is of contractual nature, only the company itself (not the company's creditors or shareholders), and more precisely the general meeting of shareholders, can seek redress for damage caused by management errors.[139] This type of action is called the *"action sociale"* or *"actio ut universi"*, which is an application of the *actio mandati* possible under any agency contract.[140] Of course, a corollary of this rule is that a receiver in bankruptcy, as well as a liquidator in case of liquidation (who both represent and act as organs of the company), may also bring such action against the directors.

2) Both the Company and third parties (e.g. creditors, a receiver in bankruptcy representing all creditors, shareholders, etc.) have a right to bring an action against directors who have committed a breach of the provisions of Article 59§2 of the Companies Act.[141] There is no need for a majority vote by the general meeting of shareholders as it is the case for the *action sociale*.[142]

6.1.2 The company's shareholders as plaintiffs

6.1.2.1 In their own name

Articles 1382 and 1383 of the Civil Code grant standing to sue to anyone (individual shareholders, creditors) who suffered a loss due to the fault of a director.[143] As a result, a shareholder who has suffered a specific, individual prejudice, to be distinguished from the prejudice suffered either by the company or the other shareholders, may introduce a claim in order to obtain indemnification of his personal, individual loss.[144] Like any ordinary liability claim, the shareholder will need to prove that a wrongful act has been committed by the director(s), that he has suffered a loss, and that the loss is the immediate and direct consequence of the wrongful act.[145]

[139] G. RAVARANI, *o. c.,* p. 457, n° 563; A. STEICHEN, *o. c.,* p. 227, n° 245.
[140] J.-P. WINANDY, *o. c.,* p. 538.
[141] THIELEN and J. DELVAUX, *o. c.*, p. 7, n° 7.2; J.-P. WINANDY, *o. c.,* p. 536; A. STEICHEN, *o. c.,* p. 231, n° 250; G. RAVARANI, *o. c.,* p. 458, n° 565*;* Sommaires de juriprudence, *Pasicrisie*, n° 29, p. 111, n° 210.
[142] A. STEICHEN, *ibid.*
[143] G. RAVARANI, *o. c.,* p. 458, n° 563.
[144] Sommaires de juriprudence, *Pasicrisie*, n° 29, p. 112, n° 211; J.-P. WINANDY, *o. c.,* pp. 536 to 537; T. A. Lux., 10 August 1891, *Pas. 3*, p. 537.
[145] A. STEICHEN, *o. c.,* p. 228, n° 246.

However, if the fault committed by the director qualifies as a management error (which will necessarily be the case if the wrongful act has been committed during the exercise of his functions), the third party's claim must be directed against the company and not the director(s).[146] Indeed, according to article 58 of the Companies Act, directors are generally subject to no personal liability in relation to the acts that they conclude in the name and for the account of the company. This is a natural consequence of the "organ theory" (*théorie de l'organe*) according to which any act concluded by the organ is supposed to have been concluded by the company itself.[147] As a result, the company "absorbs" the directors' liability for all acts concluded during the exercise of their functions, so that in relation to third parties, directors' faults will be attributed to the company.[148]

6.1.2.2 In the name of the company

Derivative claims enabling individual or groups of shareholders to introduce a claim based on article 59§1 of the Companies Act do not exist under Luxemburg law and are even formally excluded.[149] A corporate claim (*action sociale*) must be brought by the company itself, upon decision of its general meeting.[150] In other terms, in the event that shareholders suffer a loss *ut universi* by reason of a management error, it must be the general meeting of shareholders that acts against the director(s) and not a single or a group of shareholders.[151]

However, a draft bill (5730) including a wide reform of Luxembourg company law was introduced in 2007 in the Luxembourg Parliament. This bill would create a minority derivative action (*action sociale ut singuli*) following the Belgian model.

6.2 Criminal and administrative sanctions

As already mentioned *supra*, articles 162 ff. of the Companies Act provide for specific criminal liability of directors for certain offences of the Companies Act.[152] In such a case, it will be the public prosecutor who will be in charge of the enforcement.

[146] A. STEICHEN, *o. c.,* p. 232, n° 251.
[147] Ibid.
[148] *Ibid.*; P. THIELEN and J. DELVAUX, *o. c.*, p. 10, n° 9.1; T. A. Lux., 10 August 1891, *Pas. 3*, p. 537.
[149] L. METZLER, *Mélanges de droit luxembourgeois*, Luxembourg, Imprimerie de la Cour Joseph Befford, 1949, pp. 233 and 234; P. THIELEN and J. DELVAUX, *o. c.*, p. 7, n° 7.2; J.-P. WINANDY, *o. c.,* p. 539; A. STEICHEN, *o. c.,* pp. 228 and 249, n° 246; G. RAVARANI, *ibid.*
[150] A. STEICHEN, *o. c.,* p. 228, n° 246.
[151] . A. Lux., 10 August 1891, *Pas. 3*, p. 537.
[152] A. STEICHEN, *o. c.,*pp. 241 to 245.

7 CONFLICT OF LAWS

7.1 Classification under Luxembourg's private international law

According to article 159 of the Companies Act, any company that has established its central administration (*administration centrale*)[153] in Luxembourg is subject to Luxembourg law regardless of the place where its constitutional act has been signed.[154] Therefore, Luxembourg applies the theory of the real seat.[155] It could be argued that a foreign company from a Member State moving its real seat to Luxembourg could be considered to become a Luxembourg company, even if it would remain subject to the laws of the originating Member State from the point of view of the latter State. However, there is no case law in Luxembourg on this issue and the ECJ case law could be interpreted to mean that Luxembourg has to recognise that there has been no transfer of seat.

There is no definition in the Companies Act of what constitutes the central administration. However, there is some case law. A 2007 decision identifies (in a tax context) the place of the effective direction (*siège effectif de direction*) with the place where social organs (board of directors and shareholder meetings) take place.[156]

The law thus determined is called the *lex societatis*. It governs the conditions of incorporation, the functioning and dissolution of the company (in particular: the corporate personality, the capacity to act in court, the powers of the organs, the rights and duties of the shareholders, etc.).[157] As a result, the duties imposed on directors (which relate to the functioning of the company) are classified under the conflict of laws status of "company law".

According to one Luxembourg scholar, questions related to the implementation of directors' liability for breach of their duties are excluded from the scope of application of the *lex societatis*.[158] However, this opinion appears to be very isolated. There is neither a legal provision, nor any case law, that would clarify the question.

The classic approach is that the *lex societatis* applies to the issue of director's liability. This analysis is supported by the fact that regarding the relationship among shareholders and with the company, the *lex societatis* is equivalent to the *lex contractus*.

Further, questions concerning the voidability of acts concluded in the vicinity of insolvency will be qualified as insolvency law for purposes of conflict of laws.

[153] Before a law of 2006, the Companies Act used the concept of "main establishment" (*principal établissement*), which is used for natural persons.
[154] T. A. Lux., 21 April 1971, *Pas. 22*, p. 63.
[155] P.-H. Conac, Le siège social en droit luxembourgeois des sociétés, *Journal des Tribunaux Luxembourg*, 2009, p. 2.
[156] Planzer Luxembourg s.à r.l. c. Bundeszentralamt für Steuern, 28 juin 2007.
[157] J.-P. WINANDY, *o. c.,* pp. 257 and 764; A. STEICHEN, *o. c.,*p. 241.
[158] J.-P. WINANDY, *o. c.,* p. 257.

7.2 What is the law applicable to directors' duties and liability in cross-border situations?

Concerning directors' duties, it is held under Luxembourg law that the *lex societatis* applies regardless of the nationality of the directors.[159] It follows that, once a company is considered as having established its central administration on the territory of the Grand-Duchy, Luxembourg law will apply.

[159] J.-P. WINANDY, *o. c.*, p. 764; T. A. Lux., 21 April 1971, *Pas. 22*, p. 63.

LSE Enterprise

DIRECTORS' DUTIES AND LIABILITY IN MALTA

Initial author: Ylenia Grech

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1 Corporate Law and Directors' Duties in Malta

Under general principles of Maltese law directors have traditionally been regarded as both mandataries as well as agents. In their internal dealings with the company, directors can be argued to be mandataries of the company, and in their dealings with third parties they are commonly considered to be agents. More recently, as a result of the introduction of a set of "fiduciary obligations" into the Civil Code,[1] directors can also be regarded as "fiduciaries".

The legal framework in place in the area of directors' duties and liabilities cannot only be found in one particular piece of legislation but is contained in various laws and in judgments handed down by the Maltese courts. The piece of legislation that largely regulates directors' duties as well as directors' liabilities is the Companies Act,[2] principally Article 136A thereof. However, directors are also bound by duties imposed upon them by the Civil Code and other specific provisions found in various statutes, rules and codes including the following:

1. the Commercial Code (Chapter 13 of the Laws of Malta);
2. the Commercial Partnerships Ordinance(Chapter 168 of the Laws of Malta);
3. the Listing Rules, including The Code of Principles of Good Corporate Governance;
4. the Financial Administration and Audit Act (Chapter 174 of the Laws of Malta);
5. the Prevention of Financial Markets Abuse Act (Chapter 476 of the Laws of Malta);
6. the Prevention of Money Laundering Act (Chapter 373 of the Laws of Malta);
7. the Investment Services Act (Chapter 370 of the Laws of Malta);
8. the Income Tax Management Act (Chapter 372 of the Laws of Malta);
9. the Value Added Tax Act (Chapter 406 of the Laws of Malta);
10. the Disabled Persons (Employment) Act (Chapter 210 of the Laws of Malta);
11. the Employment and Training Services Act (Chapter 343 of the Laws of Malta);
12. the Duty on Documents and Transfers Act (Chapter 364 of the Laws of Malta);
13. the Electronic Commerce Act (Chapter 426 of the Laws of Malta);
14. the Data Protection Act (Chapter 440 of the Laws of Malta);
15. the Social Security Act (Chapter 318 of the Laws of Malta);
16. The Income Tax Act (Chapter 123 of the Laws of Malta);
17. The Merchant Shipping Act (Chapter 234 of the Laws of Malta);
18. The Competition Act (Chapter 379 of the Laws of Malta);
19. The Electronic Communications (Regulation) Act (Chapter 399 of the Laws of Malta);
20. The Import Duties Act (Chapter 337 of the Laws of Malta);
21. The Food Safety Act (Chapter 449 of the Laws of Malta);
22. The Occupational Health and Safety Authority Act (Chapter 424 of the Laws of Malta);
23. The Interpretation Act (Cap 249 of the Laws of Malta); and
24. The Code of Ethics for Board Directors in the Public Sector (applicable for state-controlled entities only).

It ought to be noted that for purposes of liability, various statutes, such as the Criminal Code and the Trusts and Trustees Act 'look through' bodies of persons such as companies to individual directors.

[1] Chapter 16 of the Laws of Malta.
[2] Chapter 386 of the Laws of Malta.

The area of directors' duties and liabilities is not only statute-based but is also based on general principles of law.

Academic writing in this area is generally scarce. The principal work that has analysed this area of Maltese law is A. Muscat, Principles of Maltese Company Law.[3]

1.2 Corporate landscape in Malta

Under Maltese Law, individuals who wish to associate themselves with each other can do so by forming partnerships *en nom collectif*, partnerships *en nom commandite* or limited liability companies. The most popular form is the limited liability company. This is because (a) the limited liability company is capable of being used not only for the carrying out of a commercial activity but for any lawful activity; and, (b) the limited liability company is capable of being comprised of just one member. There exist two types of limited liability companies, notably the private company and the public company.

1.2.1 Different standards applicable to listed and non-listed companies

Unless expressly provided for in a particular provision of Maltese law, there is no distinction between the rules and principles that relate to directors' duties and responsibilities in the context of a listed company and those applicable in the context of a non-listed company.

In the former case, however, the obligations imposed on directors could be deemed to be more onerous because, apart from duties and obligations set out by various laws, directors of listed companies are also subject to a specific set of rules known as the Listing Rules which are issued by the Listing Authority. These Listing Rules, which also comprise The Code of Principles of Good Corporate Governance, place additional restrictions on the qualifications required by persons intending to become directors of listed companies and their behaviour once appointed to the board of a listed company.

1.2.2 Are state-controlled companies under a specific regime?

State-controlled companies are governed by the same statutory provisions that apply to private companies. However, these provisions are supplemented by a Code of Ethics for Board Directors in the Public Sector (the 'Code'). The Code essentially sets certain standards of behaviour which are expected of persons engaged in the different fields of the public sector. It also contains certain guidelines which are useful in order to solve ethical issues that might arise in the course of carrying out related duties.

The scope of application of the Code is drafted to encompass directors of boards of statutory organisations, Government-appointed directors of companies in which the Government has a shareholding interest and government appointees on governing bodies of other organisations.

Apart from the emphasis that such a Code places on the importance of the values of integrity, honesty, loyalty to the public interest, fairness, conscientiousness and compassion, some of the main

[3] "Principles of Maltese Company Law," Andrew Muscat, Malta University Press (2007).

issues that the Code deals with are the following: conflicts and declarations of interest; acceptance of gifts or benefits; personal and professional behaviour; relations with persons holding Ministerial roles; relations with public officials; public comment; use of official information; procurement and constraints on political activity. Such duties are largely consistent with the provisions set out by Article 136A of the Companies Act.

In view of the fact that the standards that are set out by the Code are simply standards laying down the ethical behaviour that directors should exercise and do not, per se, have the force of law, it is clear that the general provisions laid down by Maltese company law should prevail in the event that any inconsistency arises between a principle stipulated in the Code and a principle of Maltese Company Law.

1.3 The board of a Maltese company

The board of directors of Maltese-registered companies takes the form of a one-tier board, comprising both executive and non-executive directors. Maltese company law does not entertain the concept of having an executive board and a separate supervisory board.

Although the Companies Act does not expressly prohibit shareholders from giving directions to the board of directors, the overall responsibility for the management of the company is vested in the directors and not in the shareholders.

1.3.1 Minimum number of directors

The Companies Act lays down the rule that the number of directors of a public company shall not be less than two. On the other hand, a private company may have just one director. The number of directors that a company may have must be stated in its Memorandum of Association. In the Memorandum of Association the number may be stated either as a fixed number or as a range.

1.3.2 Executive and non-executive directors

Although Maltese Company Law provides for the possibility for directors to be either executive directors or non-executive directors the Companies Act does not provide a clear definition or a clear legal framework as to the distinction to be made between the two types of directorships. While the model articles (found in Part I of the First Schedule to the Companies Act) simply recognise the notion of an executive director, the distinction between executive and non-executive directors features prominently in the Listing Rules and particularly in Principle 3 of The Code of Principles of Good Corporate Governance, which provides that the board of directors of a listed company "should be composed of executive and non-executive Directors, including independent non-executives."

The principal distinction between executive and non-executive directors is that whereas the former are the directors who are concerned with the actual day-to-day management, the latter are usually not involved in such management affairs of the company and under normal circumstances do not devote their full time to the company.

It may be argued that since the Act does not distinguish between executive and non-executive directors, both types of director are subject to the same duties and responsibilities. Agreements with executive directors may supplement the duties of such directors. Naturally, the provisions of the Act are mandatory and no director may obtain derogation in any circumstance. Duties and obligations arising under the provisions of Maltese law are applicable to all directors of a company registered in Malta regardless of their nationality, habitual residence or otherwise.

2 The Concept of 'Company Director' in Malta

2.1 De iure directors

2.1.1 Procedure

The Companies Act requires the first director/s of the company to be identified in the original Memorandum of Association to be delivered for registration. The Memorandum needs to contain a provision setting out *"the number of the directors, the name and residence of the first directors and, where any of the directors is a body corporate, the name and registered or principal office of the body corporate."*[4] Where a director is a corporation which is not constituted under Maltese law, a copy of a certificate or other official document (preferably issued by the relevant authority in the jurisdiction of registration of that body corporate) confirming the existence of the body corporate should also be submitted.

2.1.2 Qualification

Under the provisions of the Companies Act, directors need not be "qualified" for appointment in that directors are not necessarily required to possess any academic or professional qualification for their appointment. Nor is a director obliged to have a minimum level of proven skill, competence or experience in order to qualify for such an appointment.

It must be stated, however, that the above rule is subject to certain exceptions in relation to certain types of companies. For example, certain qualification requirements or recommendations, namely those laid down in the Code of Principles of Good Corporate Governance, do exist in the case of companies whose securities are listed on the Malta Stock Exchange. Similar rules exist in relation to the qualifications for directors of "public interest companies" and these are contained in the "Corporate Governance Guidelines for Public Interest Companies." Also, in the financial sector, persons intending to sit on boards of regulated companies are required to successfully complete a screening process carried out by the relevant authority. In this regard, individuals who are proposed to act as directors are subject to a "fit and proper" test prior to the Malta Financial Services Authority approving the appointment of such an individual. In a nutshell this implies that such a person is required to fill in a Personal Questionnaire (the 'PQ'). The PQ obliges any prospective director to disclose certain information to the Malta Financial Services Authority. Such information generally includes the following: Personal details pertaining to the said director such as his name, address, telephone number, mobile number, passport number, nationality, email, place of birth, date of birth; and

- Any qualifications or specific training that he may have obtained in the past;
- His employment history (this requires the director to disclose the occupations or positions of employment that he held within the last ten (10) years prior to submitting the said PQ;

[4] Article 69(1)(g) of the Companies Act.

- Details of bank accounts opened in his/her name within the last ten (10) years from the date at which such an individual submitted his Personal Questionnaire;
- Details concerning the individual's police conduct; and
- Details as to any present or previous directorships or company secretary posts that the individual may hold/have held.

Such an individual is also obliged to provide certain documentation to the Malta Financial Services Authority in order for such a regulatory authority to be able to determine whether such a person is indeed a fit and proper person. Such documentation includes, but is not limited to, the following:

- A certified true copy of his/her Passport or Identity Card;
- An original version of Reference Letter issued by a reputable bank;
- An original version of a Police Conduct Certificate;
- An original version of a document evidencing proof of the person's residential address;
- At least one (1) Professional Reference Letter confirming the individual's character and reputation; and
- Proof of the individual's qualifications and traineeships, if any.

2.1.3 Disqualifications

Generally speaking, apart from being subject to the additional disqualification provisions which may be laid down in particular statutes, an individual will not qualify for appointment as a director if he is subject to any one or more of the following impediments at law:

- If he is interdicted or incapacitated or is an undischarged bankrupt;
- If he has been convicted of any of the crimes affecting public trust or of theft or of fraud or of knowingly receiving property obtained by theft or fraud;
- If he is a minor who has not been emancipated;
- If he is subject to a disqualification order made under the Companies Act; or
- If his proposed appointment is in a company whose securities are listed on the Malta Stock Exchange, if he is of unsound mind, if he be convicted of any crime punishable by imprisonment or is declared bankrupt.

Furthermore, as a general rule, an individual cannot act as a sole director of a company and as its company secretary. Neither can a company have a body corporate acting as its sole director and company secretary. Nevertheless, a sole director of an exempt company can act as company secretary of the same company.

The auditor of a company also cannot, for obvious reasons, be appointed one of the directors of the same company.

Maltese law further requires prospective directors of a public company to show their consent to acting as such by executing and filing with the relevant authority the relevant consent to act as director form, whether personally or by means of an agent authorised in writing.

2.2 De facto and shadow directors

The Companies Act refrains from laying down an exhaustive provision outlining in a precise manner who a "director" is. Instead, it states that the term "director" includes *"any person occupying the position of director of a company by whatever name he may be called carrying out substantially the same functions in relation to the direction of the company as those carried out by a director."*[5]

Consequently, even though an individual is described as a manager, administrator or a governor, such an individual can still, effectively, be deemed to be a director for the purposes of Maltese law.

2.2.1 Shadow directors

Despite the fact that the term "shadow director" is not, *per se*, used in the Maltese Companies Act, such a concept is recognised. Notably, there are certain instances where the Companies Act treats as a director any person in accordance with whose directives, directions or instructions the officers of a company are, or have been, accustomed to act.

By this means, the law imposes certain prohibitions, duties or liabilities on such individuals who would not otherwise be classified as directors. However, such persons do not therefore acquire any rights or powers in connection with the management of the company.

The key criterion is that a director should or should have been "accustomed to act" in accordance with the directives, directions or instructions of the shadow director. Examples are the following: (i) a majority shareholder is in effective control of a company whose directors are accustomed to act in accordance with his directions or instructions; (ii) the directors of a subsidiary habitually comply with the directions or instructions given by the holding company's board of directors or a person to whom it has delegated its powers. The simple fact that directors are appointees of the holding company does not however make the holding company a "shadow director."

Furthermore, an individual cannot be held to be a shadow director by virtue of the fact that the directors act on any advice that he gives in his professional capacity. The Companies Act does not expressly state so but this is because a person acting in a professional capacity does not "direct" or "instruct" a company but merely advises it.

Further, a person in accordance with whose instructions or directions the directors of a company are accustomed to act cannot be deemed to be a shadow director if he gives such instructions or directions as an agent or officer of another person or body. In such a case, it might, however, be possible to consider the other person, e.g. the holding company, as the shadow director.

2.2.2 De facto directors

As stated above, the Companies Act does not lay down a precise definition of the term "director." Instead, the Act simply states that such a term includes *"any person occupying the position of director*

[5] Article 2(1) Companies Act.

of a company by whatever name he may be called carrying out substantially the same functions in relation to the direction of the company as those carried out by a director."[6]

The Companies Act therefore acknowledges the fact that a director can either be a de iure director, namely an individual who is formally appointed to the board to act as a director, or a de facto director, i.e. an individual who is not formally appointed but who assumes the role of director in practice.

2.2.3 Alternate directors

The articles of association may, and often do, provide for the appointment of alternate directors. Such an alternate director, whose authorisation to act as such depends on the director who appoints him, is usually granted the power to perform all the duties of his appointer as a director in his absence.

The articles of association of the company determine whether the alternate director must himself be a director or any person qualifies. In the vast majority of cases the alternate director does not need to be a director himself. The articles of association should, ideally, also state whether the alternate director can only attend board meetings or whether he can also act as a director outside of board meetings.

From the above, it may be concluded that an alternate director is deemed to be a director of the company for all intents and purposes of the Companies Act and that all provisions that apply to directors, including duties and responsibilities, also apply to alternate directors.

[6] Article 2(1) Companies Act.

3 The Scope of Directors' Duties under Maltese Law

Directors' duties are mainly laid down in the Companies Act. Other duties emanate from other specific legislation and from general principles of law.

3.1 Types of duties of directors

Generally-speaking, under Maltese law, the duties that pertain to directors can mainly be classified under two categories:

1. Duties of a general nature or those arising out of the juridical nature of directors under general principles of law.
2. Specific duties mostly of an administrative nature, arising primarily out of the Companies Act.

In a nutshell, it can be stated that directors are, broadly speaking, expressly bound to act honestly and in good faith in the best interests of the company, to promote its well-being, to exercise due care, diligence and skill, not to engage in self-dealing and not to misuse their powers.

Even though no particular legislative model appears to have been used, Article 136A of the Companies Act makes use of terminology which is generally used in common law jurisdictions. Maltese courts may therefore refer to common law judgments and academic writing when interpreting Article 136A.

Broadly speaking, the provisions contained in the Companies Act seem to divide the duties of directors into two main categories: (a) duties of loyalty and (b) duties of care and skill. A number of statutory duties also arise outside of the Companies Act.

3.1.1 Duties of loyalty

Under Maltese Law, the duty of loyalty is generally believed to be divided into various components, which are separately analysed in greater detail in the following sub-sections.

As stated above, in their internal dealings with the company, directors have, at least traditionally, been regarded as mandataries.[7] The relevant provisions contained in the Civil Code [8] that relate to the duties of mandataries can therefore be deemed to apply to directors. This is the case unless such duties are inconsistent with the provisions of the Companies Act or are simply incompatible with the *sui generis* position of directors.

[7] Muscat (n3) 488.
[8] Articles 1873-1879 of the Civil Code.

One of the duties contained in the Civil Code, which relates to mandataries, provides that they are obliged to carry out such duties only so long as they are vested therewith. Also, in the case of non-performance of such a duty, the mandatary is answerable for damages as well as interest.

Moreover, a mandatary is also bound to render an account of his management and of everything that he has received by virtue of the mandate, even if what he has received was not due to the mandate.

Apart from being mandataries of the company, directors can also be regarded as fiduciaries. As a fiduciary of the company, such a director is subject to the obligations that the Civil Code effectively lays down in respect of fiduciaries.[9]

Many of the fiduciary duties that are provided for in the Civil Code are either analogous to or otherwise overlap with the duties of loyalty which directors are obliged to perform and which are set out in Article 136A of the Companies Act.

For instance, a fiduciary has a fundamental duty to carry out his obligations with the utmost good faith and is duty-bound to act honestly in all cases. Any type of arrangement or agreement which lays down the contrary is prohibited under Maltese law and is therefore deemed to be null.

Notwithstanding the above, however, fiduciaries are subject to a number of specific duties (the duties of loyalty, care, and administrative duties) which can, indeed, be modified or excluded. This can be done either where the law expressly provides for such a possibility or by the express terms of an instrument in writing.

The duties of loyalty comprise: (a) the duty to avoid any conflict of interest; (b) the duty not to receive undisclosed or unauthorised profit from the director's position or functions; (c) the duty to act impartially when the fiduciary duties are owed to more than one person; and (d) the duty to return on demand any property held under fiduciary obligations to the person lawfully entitled thereto or as instructed by him or as otherwise required by applicable law.

The fiduciary's duty of care can be described as the duty "to exercise the due diligence of a bonus pater familias in the performance of his obligations."[10]

In relation to the fiduciary's administrative duties, the fiduciary is obliged: (a) to keep any property as may be acquired or held as a fiduciary segregated from his personal property and that of other persons towards whom he may have similar obligations; (b) to maintain suitable records in writing of the interest of the person to whom such fiduciary obligations are owed; and (c) to render account in relation to the property subject to such fiduciary obligations.

3.1.1.1 Duty to act honestly and in good faith in the best interests of the company

[9] Articles 1124A-1124B of the Civil Code.
[10] Article 1124A(4)(a) of the Civil Code.

Article 136A(1) of the Companies Act lays down the overarching principle that directors are bound to *"act honestly and in good faith in the best interests of the company."*[11] This duty can be deemed to lie at the heart of the directors' duties since it effectively binds directors to apply it to every decision or action which they take.

In determining whether directors acted honestly and in good faith in the best interests of the company, a Maltese court would typically analyse whether it is proved that the directors have not done what they honestly believed to be right, and normally accept that they have unless satisfied that they have not behaved as honest men of business might be expected to act.[12]

What the court therefore takes into consideration is the directors' subjective opinion as to the interests of the company as a general body, taking into account in an equal manner both the short-term interests of the present members and the long-term interests of future members.[13]

It is also pertinent to note that directors are bound to act in good faith in whatever they consider to be in the interests of the company. It is therefore the directors themselves who have to determine what they deem to be in the interests of the company and not effectively what the court considers to be so. However, if the directors fail to address the question of whether a proposed transaction is in fact in the interests of the company, they may be held to have breached such a duty.

The phrase that the Act uses - "in the interests of the company" - effectively means the interests of its members, and in exercising their powers, directors must act primarily in the interests of the members of the company as a whole. Directors owe their loyalty to the company and not to its individual shareholders, irrespective of whether such a director was appointed as a nominee of a particular shareholder or class of shareholders.[14]

A director's duty to act in the "interests of the company" may not always mean that such a director must take into consideration the company's interests as a separate legal entity. Such a duty normally requires directors to treat all shareholders in an equal manner. However, in the event that there are different classes of shareholders, and decisions may adversely affect the interests of one class and benefit another, the directors must take into account not so much the interests of the company as a whole but what is fair as between different classes of shareholders. It should also be noted that "the notion of fairness does not always mean identity of treatment."[15]

It is interesting to note that even though Maltese law dictates that a director's overriding responsibility remains towards the company as a whole despite the fact that such a director would have been appointed by a particular shareholder or class of shareholders, a legislative amendment introduced in 2005 modifies this principle in one particular context. An amendment to the Financial Administration and Audit Act by means of the Various Laws (Amendment) Act 2005 effectively entitles the Minister for Finance (or any person, body or unit delegated on his behalf) to give certain limited "directives" to any company having 51% or more of its shares held in ownership by the Government or over which the Government has effective control. Where any such directive is issued, the board of directors of the

[11] Article 136A(1) of the Companies Act.
[12] Muscat (n3) 432.
[13] Muscat (n3) 432.
[14] Ibid 435.
[15] Muscat (n3) referring to Farrar and B.M. Hannigan p. 382.

targeted company is bound to ensure that the decisions taken at board and management level respect any such directives.[16]

As can be evidenced from the above, such an amendment is inconsistent with the overarching and fundamental principle of company law, namely that the directors are to act in the best interests of the company. Such an amendment is also in breach of the stock exchange rule of equality of treatment of shareholders.

3.1.1.2 Duty to act within powers

Another corollary which stems from the general duty of loyalty that directors owe to the company can be found in article 136A(3)(e) of the Companies Act. The provision "requires directors to exercise the powers that were conferred on them and not to misuse such powers."

Theoretically speaking, the main sources of the powers of directors are the Companies Act and the company's memorandum and articles of association. Article 137(3) of the Companies Act lays down the rule that the business of a company *"shall be managed by the directors who may exercise all such powers of the company… as are not by this Act or by the memorandum or articles of the company, required to be exercised by the company in general meeting."*

In practice, the powers of directors are usually only limited by the provisions of the Companies Act, and the memorandum and articles of association are likely to provide very few provisions which limit such directors' powers.

Directors are duty-bound not to enter into any illegal acts, acts which are *ultra vires* the company's objects and any acts which the Companies Act or the company's memorandum and articles of association prohibit them from performing. They must also not perform any act or enter into any transaction which is beyond the powers conferred on directors by the articles without the sanction of the general meeting.

3.1.1.3 Duty to act in accordance with proper purposes

There might be cases in which directors act honestly for what they believed to be in the best interests of the company. However, such directors may still be liable for breach of duty if they exercise their powers for a purpose different from that for which the powers were conferred upon them.[17]

This issue applies to the exercise by the directors of any of their powers, e.g. (i) the power to make calls on shares; (ii) the power to refuse to register a transfer; or (iii) the power to order the forfeiture of shares or to expel a member.

It is the general understanding that the wider the power granted to the director, the more difficult it is to prove that he used such a power for a purpose which he was not entitled to use it for.

[16] Article 72, Financial Administration and Audit Act (Chapter 174 of the Laws of Malta).
[17] Article 136A(3)(e) of the Companies Act.

Also, the notion of directors' exercising their powers for an improper purpose has often arisen in connection with the exercise by directors of the power to allot shares. In the event that directors use such a power to strengthen their control or to prevent a third party from taking over the company, such acts performed have been held to be invalid, despite the asserted belief that the directors were acting in the best interests of the company.

3.1.1.4 Duty to avoid conflict of interest

When directors perform acts of self-dealing, these acts can broadly be classified into two distinct categories:

- Those violating the "no conflict" rule: This rule obliges directors not to put themselves in a position where their interests may possibly conflict with those of the company.
- Those violating the "no profit" rule: This rule obliges directors not to profit from their position, unless they are otherwise entitled to do so.

Article 136A(3)(c) requires directors to ensure that their personal interests do not conflict with those of the company.

Within the ambit of Maltese law, the above-mentioned prohibition is not, however, an absolute one. In other words, such a rule does not completely prohibit a director from entering into a transaction where there could possibly be a conflict of interests between his own interests and those of the company. The reason for allowing such a scenario is that in certain circumstances an outright prohibition might not be sensible, especially since the director may be the best source of goods or services to the company on whose board he sits. The Companies Act therefore regulates the procedure to be undertaken by a director in such circumstances.

Article 145(1) of the Companies Act requires any director who is in any way, directly or indirectly, interested in a contract or proposed contract with the company, to declare the nature of such conflict of interest to the other directors at the first meeting at which he knows about the potential conflict. Article 145(2) then goes on to provide that any director who does not comply will be liable to a penalty. In this sense, the relevant provisions of the Companies Act are sufficiently clear that the procedure is so fundamental that it can be deemed to be a mandatory rule which cannot be derogated from by any provision in the memorandum or articles of association. From the aforementioned provisions, it can also be inferred that the company can authorise the transaction.

The document of incorporation determines whether a director who has a personal interest in a transaction can participate in the relevant vote. The model articles of Part I of the First Schedule to the Companies Act provide that a director: *"shall not vote at a meeting of the directors in respect of any contract or arrangement in which he is interested, and if he shall do so his vote shall not be counted, nor shall he be counted in the quorum present at the meeting."*[18]

It must be pointed out that the possibility of a company allowing a director to vote on the proposed transaction, notwithstanding his interest, is permitted by Maltese law. This is however subject to the following requirements:

[18] Article 54 of the model articles contained in Part I of the First Schedule to the Companies Act.

- The director in question must declare his interest in accordance with Article 145(1) of the Companies Act; and
- The director in question must always act honestly and in good faith in the best interests of the company.

Regulation 54 of the model articles contained in Part I of the First Schedule to the Companies Act also provides that the prohibition may, at any time, be suspended or relaxed to any extent, and either generally or in respect of any particular contract, arrangement or transaction, by the company in general meeting.

3.1.1.5 Duty not to make improper profit

Apart from being bound by the duty not to act in conflict with the interests of the company, directors are also bound by the "no profit" rule. The latter can be deemed to form part of the former rule. However, it is somewhat different and both exist independently of each other. This does not, however, necessarily imply that the said rules cannot both apply to a particular case.

The aforementioned rule, laid down in Article 136A(3)(b) and (d) of the Companies Act, expressly prohibits directors from engaging in the following activities:

- Making secret or personal profits from their position without the consent of the company;
- Making a personal gain from confidential company information; and
- Using any property, information or opportunity of the company for their own or anyone else's benefit.

The rationale behind the "no profit" rule is that any profits derived from an activity pursued for the company's benefit belongs to the company and to the company alone. Directors cannot misuse or use corporate property as if it was their own and if they do they are in breach of the no profit rule.

The "no profit" rule may come into play in the following three instances:

- Misuse of information: This implies a scenario where a director obtains information which he uses to his own advantage.
- Corporate opportunity: the directors of the company should refrain from taking business opportunities that belong to the company. Where directors act for both the parent company and its subsidiary it seems logical to conclude that they owe the same duty of good management to both, and this duty is to be exercised in the light of what is best for both companies.
- Insider dealing: The concept of insider dealing applies to companies whose financial instruments are admitted to a regulated market. Insider dealing is considered to be a criminal offence under the Prevention of Financial Markets Abuse Act. In addition, a director who uses inside information to deal in the company's securities breaches his duty under Article 136A(3)(d) of the Companies Act (providing that a director should not use any information of the company for his own benefit) as well as his duty under Article 1124A(3)(a) of the Civil Code not to use information belonging to another for his own benefit.

3.1.1.6 Duty to handle directors' remuneration in a formal and transparent way

The remuneration payable to the directors of a company is usually determined by the company in general meeting. The articles usually also provide that the remuneration of the managing director and of the executive directors is to be determined in the first place by the directors but is then subject to the approval of the company in general meeting.

In relation to listed companies, Code provision 8A of the Code of Principles of Good Corporate Governance provides that the board of listed companies should set up formal and transparent procedures for developing policies on executive remuneration and for fixing the remuneration packages of individual directors. The Code recommends that the board should set up Remuneration Committees composed of independent non-executive directors with no personal financial interest other than as shareholders in the company and that no director should be involved in deciding what his or her financial remuneration will be.

3.1.1.7 Duty not to accept benefits from third parties

Under the realm of Maltese Law directors are generally prohibited from obtaining benefits, or even bribes, in connection with the exercise of their powers. However, if such directors obtain the consent of the company in general meeting or are allowed to do so by the company's memorandum or articles of association, such directors are not prohibited from obtaining benefits in connection with the exercise of their powers from third parties. The relevant article that provides for the above is Article 136A(3)(d) of the Companies Act.

3.1.1.8 Duty not to compete with the company

Under the Maltese Companies Act, the general rule is that a director may not act in competition with a company for which he serves as director. Article 143(1) lays down that a director:

> "may not, in competition with the company and without the approval of the same company given at a general meeting, carry on business on his own account or on account of others, nor may he be a partner with unlimited liability in another partnership or a director of a company which is in competition with that company."

However, the director in question will only be prohibited from engaging in activities (and therefore competing with the company) if such activities are actually performed by the company, or if they could reasonably be foreseen to be undertaken by the company in the near future. Directors should not, therefore, be prevented from engaging in activities which are specified in the company's objects clause but which are not effectively being carried out or are not reasonably expected to be carried out by the company.

It should be noted that the aforementioned prohibition does not extend to a director simply holding shares in a competing company.

As noted earlier in this report, it is important to remember that Article 143(1) does not disallow a director from competing with the company as long as shareholder approval is obtained. If the director had already been carrying on the competing business before his appointment, such approval should be sought prior to or contemporaneously with his appointment. Also, once granted, such approval cannot be revoked.

Notwithstanding the above, it is the general understanding that the possibility of a director to compete with the company (provided that the relevant shareholder approval is given at the relevant point in time) should never displace the duty of the director to act honestly and in good faith in the best interests of the company. Neither should such a director breach the no conflict rule or the no profit rule.

It can therefore be argued that in practice a director who is granted the aforementioned shareholder approval might still find it untenable to hold on to such dual roles and if he does, he might have to exercise considerable caution.

Moreover, the general practice in Malta is that shareholders do not usually exempt a director from his obligation not to compete with the company. The risks of abuse that are inherent in acting in such a dual capacity and the practical difficulties in actually proving a breach of the director's other duties are usually sufficient to persuade shareholders not to grant the said approval. The granting of shareholder approval can therefore be deemed to be more the exception rather than the rule within the ambit of Maltese law.

3.1.1.9 Duty not to give loans to directors

Article 144(1)(a) provides that it is not lawful for a company "to make a loan to any person who is its director or a director of its parent company, or to enter into any guarantee or provide any security in connection with a loan made to such person as aforesaid by any other person."

The prohibition does not apply in the following situations:

- When with the approval of the company in general meeting, such loan, guarantee or security is given to provide the director with funds to meet expenditure incurred or to be incurred by him for the purposes of the company or for the purpose of enabling him properly to perform his duties as an officer of the company;[19] or
- In the case of a company whose ordinary business includes the lending of money or the giving of guarantees in connection with loans made by other persons, to anything done by the company in the ordinary course of that business.[20]

Article 144(1) of the Companies Act also prohibits a company from paying any director by way of compensation for loss of office or as consideration for or in connection with his retirement from office. This is the case unless particulars relating to the proposed payment are disclosed to the members of the company and such a proposal is effectively approved by the company in general meeting.

3.1.1.10 Duty to exercise unfettered discretion

Despite the absence of an express provision in the law to this effect, as a general principle directors cannot enter into a valid contract, either with each other or with third parties, in order to determine how they will vote at future board meetings or, alternatively to determine how they will conduct themselves

[19] Article 144 (1)(a)(i) Companies Act.
[20] Article 144(1)(a)(ii) Companies Act.

in the future. Such behaviour can be argued to be prohibited even if there is no improper motive or purpose on behalf of the director and even if the director does not stand to gain from such an agreement.

Despite the fact that this rule has limited application, it will apply in situations where the directors purport to bind themselves as to the advice that they give to the shareholders on a matter which lies within the shareholders' power of decision.

The "no fettering" issue is also likely to arise in practice in relation to a "nominee director", that is, a director who is appointed by a particular shareholder or class of shareholders. The applicable principle here should be that a nominee director should ignore the interests of his appointer, but should consider what is in the best interests of the company as a whole.

3.1.2 Duty of care and skill

The Maltese legislator introduced an important and far-reaching provision in the Companies Act in 2003. Article 136A (3)(a) of the Companies Act obliges directors to exercise due care, diligence and skill in the exercise of their powers.

In the case of a mandate of a commercial nature (such as that inherent in a directorship), the mandatary is expected to have a certain level of experience and knowledge which is commensurate with the mandate which he has undertaken. He is therefore responsible for any lack of skill.

More concretely, Article 136A(3)(a) of the Companies Act expressly obliges directors to exercise care, diligence and skill. This duty is provided for against the background of a broader statement that is also expressly laid down in the same article, namely that the directors of a company are duty-bound to promote the well-being of the company and are responsible for the general governance of the company, for its proper administration and management and for the general supervision of its affairs.

Article 136A(3)(a) specifically obliges directors to exercise the degree of care, diligence and skill which would be exercised by a reasonably diligent person having both:

1. The knowledge, skill and experience that may be reasonably expected of a person carrying out the same functions as are carried out by or entrusted to that director in relation to the company; and
2. The knowledge, skill and experience that the director has.

Article 136A(3)(a) establishes a dual standard test, that is, both an objective and a subjective standard by which a director is to be judged in the exercise of his duties of care, diligence and skill. Despite the fact that at first glance such a dual standard test could be deemed to be contradictory, upon a closer look it becomes reasonably clear that Maltese Law requires a director to exercise the higher of the objective and the subjective standard. The subjective test only applies in the event that the director is in possession of higher attributes than those expected from a reasonable man.

The standard of care, diligence and skill which is laid out above applies to all directors, irrespective of whether they are acting as executive or non-executive directors.

3.1.3 Other statutory duties

Apart from the general duties that arise under the Companies Act as well as under the general principles of law, directors also owe several other duties which are mostly of an administrative nature. These duties emanate from the Companies Act and most of them are backed by sanctions in the form of penalties enforceable by the Registrar of Companies. The specific duties arising out of the Companies Act can be broadly categorised under six headings:

- Duties relating to the keeping of statutory registers and minute books;
- Duties relating to the filing of returns and documents;
- Duties relating to board and general meetings;
- Duties relating to record-keeping and financial statements;
- Duties relating to the liquidation of the company; and
- Miscellaneous duties: for example, directors' duties during company investigations, duties in connection with the retention of documentation as may be required in terms of anti-money laundering legislation, equality of treatment and confidentiality obligations.[21]

It is pertinent to note that, as could be expected, a level of overlap between the duties that are found in such categories does in fact occur.

It is also interesting to point out that the Act specifically burdens directors, together with the company secretary, with the responsibility for the fulfilment of certain duties that are expressly provided for by the Act.

In other cases however, the Act imposes certain other duties on the company without specifically referring to its directors. In such a scenario, however, it is clear that, in the absence of any provision to the contrary, the directors would generally be responsible to carry out such duties that are imposed on the company. This is reaffirmed by Article 150 of the Companies Act, which provides:

> "Anything required to be done by a company under any provision of this Act shall be deemed also to be required to be done by the officers of the company." [22]

It should also be observed, however, that where the Act imposes obligations on all of the officers of a company, the precise allocation of functions and responsibilities as an internal matter between the officers is something that is left to be determined by the articles and in the absence of any specific rules therein to the contrary, by the directors.

3.2 To whom are the duties owed?

3.2.1 General rule: duties are owed to the company

[21] Companies Act.
[22] Article 150 of the Companies Act.

As a general rule, directors owe their duties to the company, as opposed to the individual shareholders. This is due to the fact that directors are officers of the company that exercise its powers. They are therefore mandataries and fiduciaries of the company that are obliged to always act in the best interests of the company and to promote its well-being.

Having said that, the aforementioned general principle is not one that can be applied in an absolute manner as there could be situations where the duties are not owed to the company but are owed, for example to an individual shareholder of the company or to third parties as well.

A related issue concerns the identification of the person who may be entitled to take action on behalf of the company in respect of the initiation of litigation against the wrongdoing director or directors (see further below).

3.2.2 Duties owed to other stakeholders

Under certain circumstances, directors might owe duties to other stakeholders such as employees, creditors, the Registrar of Companies, the Commissioner of Inland Revenue and the public at large. A company owes various duties to its employees, to the authorities, and to its creditors. Just to mention a few, the company, acting through its board of directors, has the duty to file annual accounts and to notify the Registrar of certain changes that take place within the company. The company also owes duties to the public at large in that it is obliged to observe certain minimum standards of behaviour under various legislative instruments. The question remains, however, as to whether the *directors* can themselves be held to be responsible for certain duties to shareholders.

In this regard, one can state that the general rule under Maltese Company Law is that the company owes duties to such third parties and the rights of other stakeholders are generally enforceable directly against the company. Nevertheless, under certain limited circumstances, directors can be regarded as owing duties directly to other stakeholders, in which case these stakeholders may have a direct claim against the directors.

The question as to whether directors can be held to be liable towards creditors is a rather thorny issue. Can directors who have failed to exercise the prudence, diligence and attention of a *bonus pater familias* in the management of the company or who have committed a breach of duty imposed by law (such as the provisions of the Companies Act) be held liable under general principles of tort law for the loss that creditors have suffered as a result of failing to recover what is due to them from the company because of insolvency?[23] Given that directors act on behalf of the company, it is not likely that the courts will hold directors personally liable towards creditors in these circumstances.[24]

The question of the liability of directors in tort is also related to the broader question of the potential liability of a company in tort. The prevailing (and it is submitted, correct) view is that a company can be held liable in tort. It should follow that where a company is held liable in tort, it alone should be held liable. If, on the other hand, a court were to regard a company as being incapable of committing a tort, then liability should be imposed on the directors themselves.

[23] *Cf.* articles 1031-1033 of the Civil Code.

[24] The position would of course be different if the directors' conduct were to amount to fraud or to involve a breach of the criminal law. In such instances, the courts would be entitled to impose direct liability on directors vis-à-vis affected creditors of the company.

In light of a number of provisions in the Act aimed at protecting creditors of a company the question as to whether directors owe duties to the company's creditors under general principles of Maltese law is rendered less significant. The provisions laid down in the Companies Act relating to fraudulent preference, fraudulent trading and wrongful trading should, among themselves, afford creditors with sufficient protection against misconduct or serious mismanagement by the directors without the need for courts to resort to the general principles of Maltese law found under tort law.

3.3 Duties of directors towards affiliate companies

As a general principle of Maltese Company Law, a director is obliged to act in the best interests of the company that he serves. Given that within the ambit of a group of companies each company is, legally speaking, a separate entity, it would follow that the directors of a subsidiary are not entitled to sacrifice the interests of that subsidiary for the interests of any other component within the group.

One can state, therefore, that generally speaking the directors of a subsidiary owe no duties to the holding company, even though they are appointed by the holding company and may also be directors of the holding company.

In the absence of evidence relating to what the directors of the subsidiary actually considered, the test of their obligations could be argued to depend on what an honest and reasonable director would consider to be in the best interests of the company.

Despite the fact that Article 136A of the Companies Act can be argued to be fairly clear in this regard, it must be noted that in practice the affairs of the subsidiary are generally conducted in the overall interests of the group as a whole and could also be to the potential detriment of the subsidiary. In such a case, despite the controversial issue of what the interests of the subsidiary company really are under the particular circumstances in question, the directors of the subsidiary company could be argued to be walking a tight rope if they take decisions based on the interests of the group as a whole that are prejudicial to the interests of the subsidiary.

3.4 Time span of duties

The duties that directors are obliged to perform usually arise upon the date of incorporation of the company. The directors are no longer obliged to fulfil such duties at the moment at which they resign or upon the revocation of their appointment to act as directors of the company.

The duties are cumulative, they are equally important and there are no priorities between them. One could however argue that the duty to exercise reasonable care, diligence and skill is the most important out of all the duties that Maltese law imposes on directors. This is because the issue of liability is mainly determined in light of this duty.

4 LIABILITY FOR BREACH OF DUTY

Practice and case law is not yet settled in that there are still open issues, especially in relation to when directors will be liable under Maltese legislation. An example of two judgments which can be deemed to be somewhat conflicting is given in Section 4.4.1 below.

4.1 Conditions for liability

4.1.1 Breach, loss and causation

In order to be held responsible at law, directors must have either failed to fulfil a particular duty that they are required to perform, or they must have performed their duties in an incorrect manner. In addition, the breach of duty must have resulted in a loss for the person who is alleging the breach. Finally, there must be a nexus between the breach of law and the loss caused to the claimant.

4.1.2 Standard of care

4.1.2.1 General

Directors have traditionally been regarded to be mandataries of the company (in their internal dealings within the company) and the necessary effect of such a status under Maltese law is that directors are answerable not only for fraud but also for negligence in carrying out the duties laid down in the mandate.

Maltese courts have generally distinguished between three grades of culpa (that is, the absence of diligence):

1. Culpa lata: This is tantamount to gross negligence which borders on fraud;
2. Culpa levis: This is equivalent to the lack of the ordinary degree of prudence which is the due diligence of a bonus pater familias; and
3. Culpa levissima: This implies the slightest negligence which could even be committed by an attentive person.

The diligence that is generally required of a mandatary is the second one, namely the ordinary degree of prudence, diligence and attention exercised by the bonus *pater familias*. The degree of diligence is determined in accordance with the circumstances of the case and the experience of the mandatary.

In *Pulizija vs. Cassar*,[25] a non-executive chairman of a company was charged with a number of offences that breached certain provisions contained in the food safety legislation.

[25] Court of Criminal Appeal 26/08/1998.

The Court of Appeal concluded that the accused could be held to be criminally liable for breaches where the court was not satisfied that the accused had personally employed sufficient diligence to ensure that such breaches did not occur. The Court of Appeal explained that directors cannot escape criminal responsibility by merely remaining passive and by refraining from taking an active interest in whatever activities the company engages in. In order to be freed from responsibility, a director must show that, at least on a basis of probability, he had taken all the necessary steps to prevent the commission of the offence. Reliance on reports compiled by managerial staff was not deemed to be sufficient.

In *Pulizija vs Borg Costanzi*,[26] the managing director of a company that designed and manufactured garments was accused of breach of copyright and fraud.

The complainant alleged that the catalogue prepared by the company managed by the accused had unlawfully reproduced the background used in the complainant's own promotional material, which consisted of a catalogue of original garment designs. Contrary to the judgment given in *Pulizija vs Cassar*, the Magistrates Court accepted the accused's submissions which effectively entailed that the choice of the company's promotional material had been made exclusively by his company's employees and thus he was not aware of the fact that they had copied the work of another firm. The court also affirmed that the managing director's primary function should be that of focusing his attention on the essential aspects of the company's business. The court held that the preparation of the background for the company's designs in a catalogue did not form an integral part of such essential aspects of the company's business but this was merely an incidental issue.

4.1.2.2 Responsibility for performance of delegated duties

The Maltese Companies Act does not contain an express provision which lays down whether directors of a company have the possibility to delegate the powers that were granted to them under the Act as well as the Memorandum and Articles of Association.

The model articles contained in Part I of the First Schedule to the Companies Act can, however, provide us with some guidance in this respect.

The model articles lay down that directors may appoint a managing director, a director or directors holding any other executive office or offices from amongst themselves or a committee consisting of one or more persons selected from among themselves in order to delegate to him or them any of the powers exercisable by them upon such terms and conditions and with such restrictions as they may think fit, and either collaterally with or to the exclusion of their own powers. Such powers may also be revoked, withdrawn or varied from time to time.

The answer to the question whether directors have an obligation of overseeing the acts performed by their appointees is rather open and vague. However, one could argue that given the onerous responsibilities that are imposed on directors in the fulfilment of their duties and responsibilities, in delegating their powers, directors would not be completely absolved from, at least, supervising the discharge of such duties by the appointees.

[26] Court of Magistrates 25/05/1999.

4.1.3 Burden of proof

The burden of proof for the directors' failure to perform the duties that they are bound to perform at law lies on the person who alleges it.

The evidence which is required to be brought forward in order to prove that the director did not exercise the necessary diligence, skill and care that he was obliged to exercise at law is, on most occasions, based on the balance of probabilities. In the event that the particular duty that the director fails to fulfil is of a criminal nature, the nature of the proof required would be that which is beyond reasonable doubt.

4.1.4 Liability of fiduciaries at law

In addition to any other remedy that may be available at law, a fiduciary who breaches his fiduciary obligations is obliged to return any property together with all other benefits derived by him, whether directly or indirectly, to the person to whom the duty is owed.

4.2 Exemptions from liability

4.2.1 Exclusions in the articles of association

In relation to the question whether directors can mitigate their liability for acts that they performed in relation to their directorship, Article 148 of the Act provides that any provision:

"whether contained in the memorandum or articles of a company or in any contract with a company or otherwise for exempting any officer of the company… from, or indemnifying him against, any liability which by virtue of any rule of law would in the absence thereof have been attached to him in respect of negligence, default or breach of duty, or otherwise of which he may be guilty in relation to the company shall be void."

In the event that such an exemption or indemnity clause is intended to operate in respect of any future conduct of the director, a clause to this effect would also naturally be void.[27] The rationale behind the nullity of such a clause or provision is simply that any such clause might possibly have the effect of inducing the director not to satisfy the normal standards of loyalty, care and skill which the law always expects directors to abide by and follow.

It is also pertinent to point out that the wording used in Article 148 of the Companies Act - "or otherwise" - does not only prohibit such exemption or indemnity clauses from being contained in the memorandum or articles of association of the company or in any contract with the company but prohibits any sort of arrangement to that effect.

Despite the fact that the Companies Act generally prohibits the insertion of any indemnity provisions in any types of arrangements between the company and its officers, this is not to say that a company

[27] Article 148 of the Companies Act.

may not indemnify the director against liability incurred by him in defending any proceedings in which judgment is given in his favour or in which he is acquitted. The Act in fact allows a company to indemnify such a director in this respect.

4.2.2 Ratification

Notwithstanding the above, the statutory invalidation of an exempting provision does not seem to prohibit a resolution being passed by the general meeting that effectively releases a director from a breach of duty which has already been committed and which he already fully disclosed.

4.2.3 Cap

Within the ambit of Maltese law there is no pecuniary cap on the liability of directors. In the event that directors are held to be personally liable for breach of any of the duties expected from them in Maltese law, they will be liable for such debts in their personal capacity with all their personal assets, present and future.

4.3 Insurance

A company may purchase and maintain in force insurance against liability for the benefit of its directors and may also pay the premium out of the company's funds. Naturally, a director may also personally purchase and maintain in force a policy against liability.

A company may also take out an insurance policy in order to cover itself for any loss that it suffers as a result of the director's breach of duty or to indemnify it against its liability to third parties for wrongs committed by a director. Alternatively, a policy may be taken out by the director himself in order for him to be indemnified against his liability to the company or to a third party. No conditions and limits have been imposed, either by statute or through case-law, with regard to insurance coverage.

4.4 Consequences of liability

4.4.1 Breach of fiduciary duties

In the event that a director receives a benefit in order to secure a particular contract with a third party, the company may be able to annul the contract on the basis that one of the essential conditions for the validity of the contract, namely that of a "lawful consideration" or causa, would be missing. The company would also be able to start an action on the basis of the specific remedy of annulment contemplated by Article 1051A(7) of the Civil Code and would have the right of action against the said director for compensation for the damage that he caused to the company by accepting such a benefit from the third party.

On the other hand, if the director breaches Article 143(1) of the Companies Act, the company may either take action for damages and interest against the director or alternatively demand payment of any profits made by him in contravention of the rule. It is important to point out that the company does not need to have suffered a loss in order to bring an action under Article 143(1). Also, any action exercised by the company does not prejudice any other remedy which the company may have against the director for breach of his duties.

A breach of Article 144(1) of the Companies Act would lead to the said loan, guarantee or security being unlawful. Put differently, one of the essential conditions for a valid contract to exist - a "lawful consideration" or "causa" - will be missing and the contract will be *null ab initio*.

The liability of several directors who breach their duties is joint and several (Article 147(1) of the Companies Act).

4.4.2 Breach of administrative duties

4.4.2.1 Penalties

Administrative duties such as the duty to keep registers of members, the duty to file a copy of the annual accounts and the duty to file returns of allotments, shares transfers and changes amongst directors (as set out above) are backed by respective sanctions in the form of penalties which are enforceable by the Registrar of Companies. Generally, these penalties are enforced against the directors personally.

Further, the breach of a number of duties may constitute a criminal offence punishable by a fine and/or a term of imprisonment.

4.4.2.2 Criminal sanctions

Apart from potential liability under the administrative and penal provisions of the Companies Act, directors may be subject to administrative and penal sanctions under various other laws. In the financial services sector, for example, liability, both of an administrative and of a penal nature, could arise under a number of laws, including the Prevention of Financial Markets Abuse Act, the Prevention of Money Laundering Act, and the Investment Services Act.

Directors may also be exposed to criminal liability under a variety of other laws including, but not limited to, the following: the Social Security Act, the Income Tax Act, the Income Tax Management Act, the Value Added Tax Act, the Merchant Shipping Act, the Competition Act, the Electronic Communications (Regulation) Act, the Data Protection Act, the Import Duties Act, the Electronic Commerce Act, the Food Safety Act and the Occupational Health and Safety Authority Act.

Furthermore, the imposition of criminal liability on directors for offences usually arises by virtue of Article 13 of the Interpretation Act,[28] which expressly provides as follows:

> "Where any offence under or against any provision contained in any Act… is committed by a body or other association of persons, be it corporate or unincorporated, every person who, at the time of the commission of the offence, was a director, manager, secretary or other similar officer of such body or association, or was purporting to act in any such capacity, shall be guilty of that offence unless he proves that the offence was committed without his knowledge and that he exercised all due diligence to prevent the commission of the offence."

The practical implications of Article 13 have been considered in a number of judgments. Two judgments that offer a somewhat contrasting approach to the issue are *Pulizija vs. Cassar* and *Pulizija vs Borg Costanzi*, which were analysed in great detail earlier in this report.

4.4.2.3 Personal liability for debts of the company

Under certain Maltese legislation, personal liability for debts which would in the normal course be payable by the company can under certain conditions be imposed on directors.

Two significant examples appear in the Income Tax Management Act and in the Social Security Act. The former lays down that the manager or other principal officer of every body of persons must pay tax out of the property of that body of persons but that he will be personally liable for payment, jointly and severally with any other person responsible therefore, if he had in his possession or control any property belonging to the body of persons which could have been used to pay the tax then due.

The Social Security Act provides that "where any act, matter or thing required to be done or to be omitted to be done by or under [the Act] is to be done or to be omitted by a body or other association of persons, such act, matter or thing shall also be required to be done or to be omitted personally by the manager or other principal officer of such body or association."

4.5 Duration of liability

Under Maltese law, directors can only be held liable for a breach of any of the duties and obligations imposed on them during their term of appointment. When a director's term of appointment expires, the director will remain liable for the aforementioned act/s but will not be liable for any acts that are performed by the directors of the company after his resignation.

[28] Chapter 249 of the Laws of Malta.

5 Duties in the Vicinity of Insolvency

The concept of "the vicinity of insolvency" or "twilight zone" is acknowledged by Maltese legislation. The main focus of the duties that a director has to fulfil could be argued to shift from the shareholders to the creditors when the company is in the vicinity of insolvency or faces serious financial difficulties.

5.1 The meaning of 'vicinity of insolvency'

The meaning of "in the vicinity of insolvency" is clearly laid down in Article 329A of the Companies Act. This provision states as follows:

"Where the directors of a company become aware that the company is unable to pay its debts or is imminently likely to become unable to pay its debts, they shall forthwith, not later than thirty days from when the fact became known to them, duly convene a general meeting of the company by means of a notice to that effect for a date not later than forty days from the date of the notice for the purpose of reviewing the company's position and of determining what steps should be taken to deal with the situation, including consideration as to whether the company should be dissolved or, where applicable, whether the company should make a company recovery application in terms of article 329B."

Put differently, one could state that a company is deemed to be "in the vicinity of insolvency" if:

- The Company is unable to pay its debts; or
- The Company is imminently likely to become unable to pay its debts.

Article 214(5) then goes on to define the aforementioned terms in more detail:

"A company shall be deemed to be unable to pay its debts -

(a) if a debt due by the company has remained unsatisfied in whole or in part after twenty-four weeks from the enforcement of an executive title against the company by any of the executive acts specified in article 273 of the Code of Organisation and Civil Procedure; or
(b) if it is proved to the satisfaction of the court that the company is unable to pay its debts, account being taken also of contingent and prospective liabilities of the company."

Significantly, the mere fact that a creditor has been demanding payment from a company for a number of years and has not received payment does not necessarily imply that a company is "unable to pay its debts." In the first place, an executive title is required.[29] Usually, the executive title is a court judgment.[30] The judgment must be a *res iudicata* (final and definite judgment with no possibility of

[29] Article 253 of the COCP gives a list of executive titles: (a) judgments and decrees of the courts of justice of Malta; (b) contracts received before a notary public in Malta, or before any other public officer authorised to receive the same where the contract is in respect of a debt certain, liquidated and due, and not consisting in the performance of an act; (c) taxed bills of judicial fees and disbursements, issued in favour of any advocate, legal procurator, notary public, perit (architect), judicial referee or witness, unless such taxed bill are impugned according to law; (d) awards of arbitrators registered with the Malta Arbitration Centre; and (e) bills of exchange and promissory notes issued in terms of the Commercial Code (f) mediation agreements and (g) decisions of the Consumer Claims Tribunal.
[30] Article 253(a) of the COCP.

appeal). With a final judgment in his favour, a creditor may issue one or more executive acts[31] against the debtor to enforce his executive title (the judgment). However, only when a period of 24 weeks has elapsed after the issue of any of these executive warrants and payment in full has not been effected, could it be said that the company is "unable to pay its debts" within the meaning of the first test.

The court is given a discretion to ignore, if it so wishes, the first test and look at the assets and liabilities of the company. By analysing the assets and liabilities of the company the court will be able to determine whether, in the long term, the company will be able to satisfy its obligations towards their creditors, after taking into account contingent and prospective liabilities.

Therefore, a company is "unable to pay its debts" (and is deemed to be insolvent) when any one of these tests is satisfied.

5.2 Change of existing duties

Under normal circumstances, namely when the company in question is not facing financial difficulties, directors are expected to act in the interests of the company and its shareholders. However, as will be seen, within the context of a company facing financial difficulties, directors primarily have to bear in mind the interests of its creditors. We can therefore observe a shift in the duties and responsibilities of the directors of a company.

5.3 Rules to be taken into account by directors of companies in distress

5.3.1 Fraudulent trading and wrongful trading (articles 315 and 316 of the Companies Act)

5.3.1.1 Fraudulent trading

The Act imposes liability on any person (including a director) who is a party to "fraudulent trading".

The Act provides that if in the course of the winding-up of a company, whether by the court or voluntarily, it appears that any business of the company has been carried out with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court on the application of the official receiver, or the liquidator or any creditor or contributory of the company, may, if it thinks proper to do so, declare that any person who was knowingly a party to the carrying out of the business be personally responsible without any limitation of liability for all or any of the debts or other liabilities of the company as the court may direct.[32] Furthermore, where the business of a company is carried out with such intent or for such fraudulent purposes, every person who was

[31] Article 273 of the COCP provides a list of executive acts: (a) warrant of seizure of movable property; (b) warrant of seizure of immovable property; (c) warrant of seizure of a commercial going concern; (d) judicial sale by auction of movable or of immovable property or of rights annexed to immovable property; (e) executive garnishee order; (f) warrant of ejection or eviction from immovable property; (g) warrant in factum; (h) warrant of arrest of sea vessels; (i) warrant of arrest of aircraft; and (j) warrant *in procinctu*.

[32] Article 315(1) of the Act.

knowingly a party in the carrying out of the business shall be guilty of an offence and liable on conviction to a fine of not more than €232,937.34 or imprisonment for a term not exceeding five years, or to both such fine and imprisonment.[33]

The provision enables the court to declare each individual (including a director) who has been a party to the company's fraudulent trading to be personally liable without any limitation of liability for all or any of the debts or other liabilities of the company as the court may direct.[34] Unlike Article 316 on Wrongful Trading, this provision does not impose any restriction in terms of the period of time prior to the company's winding-up during which the event must have taken place in order for liability to be imposed.

The provision applies to any person, including a *de iure* and *de facto* director.

5.3.1.2 Wrongful trading

Liability for wrongful trading may be imposed when a company is insolvent and being wound up and it appears that a person who was a director of the company knew, or ought to have known, prior to the dissolution of the company, that there was no reasonable prospect that a company would avoid being dissolved due to its insolvency.[35] It is apparent that the essence of the activity consists of the company's continuing to trade and incur liabilities after the time when it was known, or ought to have been realised by the directors, that insolvent liquidation was inevitable or, at least, that it was a reasonable probability.[36]

In such a scenario, the court may, on the application of the liquidator of the company, declare the directors liable to make a payment towards the company's assets as the court thinks fit.[37] However, the court shall not grant an application for wrongful trading if it is shown that the directors took every step they ought to have taken with a view to minimising the potential loss to the company's creditors.[38] It is pertinent to point out that in minimising such a loss, the directors ought to give due attention to the fact that the loss is to be minimised for the benefit of the general pool of creditors and not for the benefit of individual creditors. Any actions taken by the directors at the relevant time with respect to particular creditors could well be interpreted by the courts as being preferential with respect to these creditors and detrimental to the general pool of creditors.

In assessing the director's behaviour, the court takes into account both: (i) the knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by or entrusted to that director in relation to the company (the objective test); and (ii) the knowledge, skill and experience that the director has (the subjective test).[39] The provisions on wrongful trading also apply to shadow directors.[40]

[33] Article 315(2) of the Act.
[34] Article 315(1) of the Act.
[35] Article 316(1) of the Act.
[36] Fletcher I, The Law of Insolvency 4th ed (2009) p. 858.
[37] Article 316(2) of the Act.
[38] Article 316(3) of the Act.
[39] Article 316(4) of the Act.
[40] Article 316(5) of the Act.

Once liability is established, the court can order the director to make such contribution (if any) to the company's assets as the court thinks proper.

5.3.2 Prohibition to misapply property of the company

The director must not misapply or retain or become accountable for any money or other property of the company, or be guilty of any improper performance or breach of duty in relation to the company (Article 312 of the Companies Act).

Article 312 is important because, similar to wrongful and fraudulent trading, it is a remedy which allows the liquidator to supplement the estate of the debtor company. The court may, upon the application of a liquidator or a creditor, examine the conduct of the directors. If it appears that the directors have misapplied or retained or become accountable for any money or property of the company or have been guilty of breach of duty in the course of the winding-up, they may be asked to repay, restore or contribute such sum to the company's assets by way of compensation.

5.3.3 Other offences

5.3.3.1 Fraud in anticipation of winding-up

When a company is being wound up, any person being a past or present officer (including a director) of the company, shall be guilty of an offence if, within the twelve months immediately preceding the date of winding-up, he has committed one of a series of specified acts (such as, for example, concealing any part of the company's property or falsifying the accounting records of the company). [41] However, it shall be a defence for a person to prove that he had no intention to defraud or conceal the affairs of the company.[42] These provisions also apply to shadow directors.[43] A person who is found guilty shall be liable on conviction to a fine of not more that €232,937 or imprisonment not exceeding five years or both.[44]

5.3.3.2 Fraud by officers of companies being wound up

When a company is being wound up voluntarily or by the court an officer (including a director) shall be guilty of an offence if he has made or caused to be made any gift or transfer of, or charge on, or has caused or connived at the enforcement of any executive title against the property of the company or has concealed or removed any part of the property of the company since or within two months before the date of any unsatisfied judgment or order for payment of money against the company.[45]

[41] Article 307(1)(a) -(h) of the Act.
[42] Article 307(3) of the Act.
[43] Article 307(5) of the Act.
[44] Article 307(6) of the Act.
[45] Article 308(1) of the Act.

5.3.3.3 Other offences by officers of companies being wound up

The Act sets out a further list of offences which may be committed by a past or present officer (including a director) of a company. This list includes offences relating to the failure of officers to disclose all information and to assist the liquidator[46] or to keep proper accounting records during the period of two years immediately preceding the winding-up.[47]

5.3.3.4 Duties of directors when there is a serious loss of capital (public companies)

The Act also imposes a positive duty on the directors of a public company in situations when there is a serious loss of capital. The Act provides that where the net assets of a public company are half or less of its called up issued share capital, the directors shall, not later than thirty (30) days from the earliest day on which that fact is known to any director of the company, duly convene a general meeting of the company by means of a notice to that effect for a date not later than forty (40) days from the date of the notice for the purpose of considering whether any, and if so, what steps should be taken to deal with the situation, including consideration as to whether the company should be dissolved.[48] If such a meeting is not called, each of the directors of the company in default shall be liable to a penalty, and, for every day during which the default continues to a further penalty.[49]

5.3.3.5 Criminal Liability under the Criminal Code

The Criminal Code contains a number of offences relating to bankruptcy (Articles 191 to 195 of the Criminal Code). In particular, Article 192 states that a bankrupt trader shall be declared guilty of simple bankruptcy and shall be punishable with imprisonment if he is found guilty of any one of a series of circumstances, for example giving “undue preference to any creditor to the prejudice of the general body of creditors”. This provision may potentially involve the directors of a company that has stopped payments and that has given an undue preference to a creditor.

[46] Article 309(1)(a) -(g) of the Act.
[47] Article 314 of the Act.
[48] Article 104(1) of the Act.
[49] Article 104(3) of the Act.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue?

6.1.1 The company as a plaintiff

As outlined above, generally the board of directors or the general meeting take the final decision to initiate litigation.

6.1.2 The company's shareholders as plaintiffs

6.1.2.1 In their own name

In somewhat rare circumstances directors may be regarded as owing their duties to individual shareholders. In such a case, the latter are able to file proceedings against the defaulting directors in their own name rather than on behalf of the company.

6.1.2.2 In the name of the company

In view of the fact that it is the board of directors which is vested with all of the powers to manage the business of the company and to determine any issues which have not specifically been reserved to the shareholders of the company, and in light of the principle that directors must act bona fide in the interests of the company as a whole (as opposed to the interests of the company's individual shareholders), it can be concluded that minority shareholders cannot direct the board to take action in respect of the company.

6.1.2.3 Unfair prejudice

Article 402 of the Companies Act provides that "any member of a company who complains that the affairs of the company have been or are being or are likely to be conducted in a manner that is, or that any act or omission of the company have been or are or are likely to be, oppressive, unfairly discriminatory against, or unfairly prejudicial, to a member or members or in a manner that is contrary to the interests of the members as a whole, may make an application to the court for an order under this article."

The unfair prejudice action laid down above does not, essentially, provide for the right of a shareholder to bring a personal action in order to enforce his individual rights against the persons who were involved in the management of the company.

In the event that the court is satisfied that the complaint is well-founded and that it is just and equitable to do so, the court may make such orders under such terms as it deems fit. Article 402(3) lays down an exhaustive list of orders that the court can make in such situations.

While it may be true that the unfair prejudice action is effective and far-reaching, it can also be argued that in some respects the remedy is limited. This is because, as mentioned above, it lists, in an exhaustive manner, the orders that the court may make when it is asked to provide a remedy in terms of this action.

6.2 Criminal and administrative sanctions; disqualification

Criminal and administrative sanctions were already discussed above at 4.4.2. In addition, a director can be subject to a disqualification order. In order for this to take place, the Attorney General or the Registrar of Companies must file an application requesting the court to make a disqualification order against the director who is found guilty of an offence under the Companies Act, other than an offence punishable only with a fine, or who has breached any requirement of the Act with the consequence that the director becomes liable to contribute to the assets of the company or becomes personally liable for the debts of the company.

According to Article 320(2), the court may make a disqualification order if it is satisfied that:

1. The person is or has been a director of a company which at any time has become insolvent, whether while he was a director or subsequently; and
2. His conduct as a director of that company, either taken alone or taken together with his conduct as a director of any other company or companies, makes him unfit to be involved in the management of a company.

The disqualification order may be made for a minimum period of one year and for a maximum period of fifteen years. Moreover, the effects of a disqualification order are that the director cannot, without permission of the court, occupy the following posts:

- A director or secretary of a company;
- A liquidator or a provisional administrator of a company;
- A special manager of the estate or business of a company; or
- Concerned in any way, whether directly or indirectly, or take part in the promotion, formation or management of a company for a specified period beginning with the date of the order.

6.3 The responsibility of the board as a whole

According to Maltese Company Law, the board of directors, acting as a body, is subject to the specific duties and liabilities that are applicable in respect of individual or corporate directors separately.

As clearly stipulated in Article 147(1) of the Companies Act, the liability of directors of a company is joint and several. The background is that directors are meant to act collectively as a board. The practical effect of this rule has, however, been somewhat undermined because significant exceptions are provided for by Maltese legislation.

The first exception can be found in the second part of Article 147(1) of the Companies Act. It provides that where a particular duty has been entrusted to one or more specified directors, only these directors are liable in damages. Put differently, where a particular responsibility is allocated by the company to a particular director, responsibility only attaches to that director. This exception considerably diminishes the effectiveness of the principle of joint and several liability by enabling directors to allocate responsibilities amongst themselves and thereby lessen their potential exposure to liability.

The second exception to the principle of joint and several liability for breach of duty can be found in Article 147(2)(a) of the Companies Act. Pursuant to this provision, a director shall not be liable for the acts of his co-directors if he proves that he did not know of the breach of duty before or at the time of its occurrence, and that on becoming aware of it he signified to the co-directors his dissent in writing. Although directors should, and in the vast majority of occasions do, act collectively as a board, it sometimes happens that one or more directors act without the board's knowledge or approval. In such a scenario, academics have argued that it is justifiable not to hold such a director (who has not been involved in the act) liable in damages (as long as, upon becoming aware of the act, he immediately provides his dissent in writing).

The third exception to the principle of joint and several liability is that a director will not be liable for the acts of his co-directors if he proves that, knowing that the co-directors intended to commit a breach of duty, he took all reasonable steps to prevent it. It should be noted that a director cannot escape liability by simply resigning without previously taking all reasonable steps in that sense. This third exception is laid down in Article 147(2)(b) of the Companies Act.

7 Conflict of Laws

7.1 Law applicable to duties of loyalty and care arising under company law

The duties and liabilities which are contained in various parts of the Maltese Companies Act only apply to companies registered and formed under Part V of the Act or the Commercial Partnerships Ordinance. Article 2 of the Companies Act defines a company within the meaning of the Act as "a company formed and registered under Part V of this Act or the Ordinance." Accordingly, Malta uses the company's place of incorporation as the decisive factor in identifying the law that should be applicable to the company.

The necessary implications are that the provisions of the Companies Act only apply to companies incorporated in Malta. Foreign companies are deemed to be governed by the respective laws in their places of incorporation. The place where the company's operations are actually based is irrelevant.

7.2 Law applicable to duties and liabilities arising under tort law

Under Maltese law, the law applicable to a non-contractual obligation arising out of a tort or delict is the law of the country in which the damage occurs, regardless of the country or countries in which indirect consequences of the event may occur.

Two major exceptions to the above-mentioned rule are the following:

1. When the defendant and the claimant are both habitually resident in the same country at the time when the damage occurs, it is the law of that country that applies.
2. When the event is manifestly more closely connected with a different country, it is the law of that country that applies.

Maltese Law also generally allows the parties the freedom to choose the law which applies to the non-contractual obligation in question, either by common agreement after the event giving rise to the damage that took place, or between business people by an agreement freely negotiated before the event giving rise to the damage that occurs. Such a choice cannot, however, prejudice the rights of any third party and cannot be invoked when all the elements relevant to the situation relate to a country other than the one chosen.

7.3 Law applicable to duties and liabilities arising in the vicinity of insolvency

The law applicable to the duties and liabilities of directors of Maltese companies which arise in the vicinity of insolvency would be that of Maltese Law.

LSE Enterprise

DIRECTORS' DUTIES AND LIABILITY IN THE NETHERLANDS

Initial author: Sybren de Beurs

CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in Netherlands

The Netherlands is a civil law jurisdiction. Dutch law is largely laid down in statutory provisions. Traditionally a distinction is made between private and public law. Most of Dutch private law is implemented in the Dutch Civil Code (**"DCC"**). In company law a division can be made between companies with a separate legal personality and those without a separate legal personality. The second book of the DCC contains specific provisions concerning corporations with a separate legal personality. These rules are mandatory unless the statute itself provides for the possibility to deviate, for instance in the articles of association.[1] Some rules are specific and prescriber or forbid certain dealings. Other rules provide general guidance, allowing the development of principles of reasonableness and fairness in case law ('open' rules). Aside from statutory provisions and case law, especially that of the Dutch Supreme Court (**"DSC"**), parliamentary documents play a significant role in Dutch Law when it comes to understanding the meaning and the scope of statutory provisions. Given the amount of statutory law and the limited number of cases that come before the DSC, academic work is important in the Netherlands for the interpretation of statutory and case law concepts.

Aside from statutory law, corporate governance within listed companies in the Netherlands is regulated through a Corporate Governance Code which intends to function as a form of self-regulation.[2] Listed companies should either adhere to the principles set out in the Code or explain in their annual accounts why they deviate from it. A point of discussion within the Dutch legal literature is the extent to which the principles set out in the Corporate Governance Code have an effect on corporate governance of non-listed companies, as these principles 'colour' the open rules.[3]

1.2 Corporate landscape in the Netherlands

Public companies in the Netherlands are considered to have a dispersed ownership structure.[4] Research from 2005 indicated that about 75% of the shares of listed companies were in foreign hands.[5] Also, Dutch institutional investors play a big role, although they expand their investment to companies abroad. For example, in the first quarter of 2010 the pension funds had an amount of EUR 701 billion of investments outstanding, which amounted to about 135% of the Dutch gross national product.[6]

Dutch corporate law adheres to the stakeholder theory and the management board in principle does not have to take specific instructions of the general meeting of shareholders, even though the latter

[1] Section 2:25 DCC.
[2] The Dutch Corporate Governance Code and an English translation can be downloaded from http://www.commissiecorporategovernancecode.nl.
[3] C.R. Huiskes, Een corporate governance code voor niet-beursgenoteerde ondernemingen, JutD 2004/12, p. 19-24.
[4] J. Otten, P. Heugens, E. Schenk, *Corporate Governance Reforms and Firm Ownership Around the World*, Tjalling C. Koopmans Research Institute, 06/01 (2006).
[5] R. Abma, 'De veranderende positie van de aandeelhouder. Import van normen en waarden uit Angelsaksische landen', *Goed Bestuur* 2006-2.
[6] EPN, 9 November 2010.

can ultimately remove the board and appoint other candidates[7]. Thus, if the shareholders and management do not agree on a common strategy, this can create tension.

1.3 The board of a Netherlands' company

The main difference under current law between the public company with limited liability, the Naamloze Vennootschap (abbreviated as N.V.), and the private company with limited liability, is that the latter does not allow the use of bearer shares. Until the 1960s the view was that the N.V. could be described as a contractual agreement between shareholders with legal personality. This has now been replaced by an institutional approach, whereby companies with share capital are considered to be largely independent of their founders.[8]

The N.V. can opt for a two-tier board structure in its articles of association by installing a supervisory board.[9] The supervisory board oversees the management board's activities. It is generally held that both executive and supervisory directors are to act in the interests of the company (see paragraph 3.2). Once an N.V. reaches certain thresholds, which relate to size, and continue to meet these thresholds for a certain amount of time, a special two-tier board structure for large companies becomes mandatory.[10] Recently legislation facilitating the use of a one-tier board has been adopted, *inter alia* to make Dutch companies more attractive to foreign investors. This legislation will enter into effect on 1 January 2013.[11]

[7] There is one exception to this rule. Section 2:129 sub 4 DCC provides that the articles of association can provide that directors are obligated to follow instructions of the general meeting of shareholders on general lines of policy on areas which are specified in the articles of association.
[8] J.B. Huizink, *Rechtspersoon, vennootschap en onderneming,* p. 18-19.
[9] Section 2:140 DCC.
[10] Section 2:153 and 2:154 DCC.
[11] Kamerstukken I, 2011-2012, 31 763, nr. A, Wetsvoorstel bestuur en toezicht (*Management and supervision act*).

2 CONCEPT OF 'COMPANY DIRECTOR' IN THE NETHERLANDS

2.1 *De iure* directors

2.1.1 Requirements to become a *de iure* director

The requirements for becoming a *de iure* director are:

1. Appointment by either the deed of incorporation, a valid shareholders' resolution, a valid supervisory board resolution in case of a mandatory two-tier board structure for large companies, or by appointment by the Dutch Enterprise chamber in case of inquiry proceedings into the company affairs by way of immediate relief.[12] Under normal circumstances a void resolution cannot be held against a third party who acted in good faith. However, with regard to the appointment of directors, section 2:16 DCC stipulates that if an appointment resolution is void, this can be held against the director, but the company is obliged to compensate the director for the damage suffered as a result of the voidance;
2. Acceptance by the director of his appointment, although some authors have argued that this is not a constitutional prerequisite for appointment;[13] and
3. The director must be compliant with qualification requirements, if these are provided for in the articles of association. Common requirements are, for instance, being a Dutch resident or holding a certain interest in the relevant company. However, the qualification requirements can be set aside by a resolution of the general meeting of shareholders adopted with a two-thirds majority.

2.1.2 Who can be *de iure* director

Under Dutch law natural persons as well as legal entities can become a company director. Liability of natural persons cannot be avoided by using a legal entity as a director. Section 2:11 DCC provides that liability incurred by a legal entity acting as a director will be incurred jointly and severally by the directors of that legal entity.

The board of directors collectively bears responsibility for the management of the company, which includes the day-to-day management and the strategy of the company. It is generally accepted that some tasks can be delegated to individual directors in the articles of association, board regulations or otherwise, but the extent to which this is possible and the extent to which the board of directors has the obligation to monitor the proper discharge of a delegated task is a point of discussion.[14]

[12] Section 2:130 DCC.
[13] Blanco Fernandez, *Ondernemingsrecht* 2000, 17, p. 474 a.f.
[14] Asser/Maeijer/Nieuwe Weme/Van Solinge 2009, nr. 417. See further section 3.1.1 below.

2.2 *De facto* and shadow directors

In Dutch corporate law there is no strict distinction between a *de facto* director and a shadow director (hereinafter reference will only be made to *de facto* directors). In fact, the notion has only been incorporated in one section of the DCC[15]. Section 2:138 sub 7 provides that someone who (partly) determines the policy of the company as if he was a director will be considered to be director of the company for the purpose of section 2:138 DCC (liability in case of insolvency).[16] Examples of potential *de facto* directors are majority shareholders, supervisory directors and managers. Furthermore, even though the internal duty to properly manage the company (see section 3.1.1) does not directly apply to *de facto* directors, internal liability by those de facto directors towards the company can remain relevant to the extent that such a director who is also an employee of the company causes damage towards a third party and the act which causes the damage is a result of intent or wilful neglect.

[15] Although it should be noted that pursuant to section 2:23a DCC the liquidator of a dissolved legal entity has the same authorities, duties and liabilities as a director in so far as these are compatible with its task as liquidator.
[16] Section 2:138 DCC applies to public companies; for private companies section 2:248 DCC contains similar rules.

3 THE SCOPE OF DIRECTORS' DUTIES UNDER DUTCH LAW

3.1 Types of directors' duties

There are no specific duties of directors to avoid risk and reputational damage under Dutch law. However, Dutch law provides for a general duty to properly manage the company (section 2:9 DCC). In other cases duties can be derived from the sanction of liability when not complying with statutory provisions and standards developed in case law. In a broad sense a distinction can be made between internal liability (to the company) and external liability (to third parties, creditors, individual shareholders etc.). In the same manner a distinction can be drawn between internal (fiduciary) duties and external duties. When making this distinction, it should be kept in mind that it may well be that the breach of an external duty eventually leads to internal liability.

3.1.1 Internal duty: proper management of the company

Section 2:9 DCC stipulates that a director must properly perform his duties. In principle, the board of directors bears the collective responsibility for managing the company, although specific tasks can be assigned to individual managers in the articles of association, board regulations or by agreement. However, the extent to which such allocation is possible is uncertain and legal authors hold different views in this respect.[17] It appears to follow from case law that important matters such as company and financial policies will always fall within the collective responsibility of the management board.[18] The recently implemented "Act of Management and Supervision" sheds some light on this matter, as it specifically states that the tasks of a director include all tasks that are not assigned to other directors by law or by the articles of association,[19] with the proviso that responsibility for the general course of affairs remains a collective responsibility of the board of directors (which would appear to include important matters such as company and financial policies).[20] The starting point remains, however, that the management of the company is the task of the board of directors as a whole. Even when certain tasks are delegated, the board is required to monitor the tasks which are assigned to individual directors. This duty is owed to the company.

Section 2:9 DCC is not an obligation to achieve a certain result. In case law, the norm has been further developed to the extent that a director is required to meet the standard of care which may be expected of a director who is competent for his task and performs this task with diligence.[21] Whether directors have been found liable on the basis of section 2:9 DCC depends heavily on the circumstances of the individual case. In general, it is held that violating provisions of the articles of association of the company which aim to protect the interests of the company or its shareholders, in principle, establish liability of a director.[22]

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[17] Asser/Maeijer/Nieuwe Weme/Van Solinge 2009, nr. 417.
[18] Y. Borrius, *Director's Liability: The Netherlands, European Company Law*, p. 248.
[19] Section 2:129a sub 3 (new).
[20] J.B. Huizink, 'Artikel 2:9, enkele observaties', *Hoe verder met collegiaal bestuur in Nederland?*, p. 9, Kluwer, 2011.
[21] Staleman van der Ven.
[22] Berghuizer Papierfabriek.

Section 2:8 DCC stipulates that the legal entity and those who by virtue of the law and the articles of association are involved in its organisation must act in accordance with the principles of reasonableness and fairness. This provision applies also to the board of directors and the supervisory board as corporate bodies of the company and reasonableness and fairness are owed towards the company and those who are involved in the organisation of the company, such as shareholders, directors and supervisory board members. It has been held that, pursuant to section 2:8 DCC, the persons involved in the organisation of the company have to take into account the legitimate interests of the other persons involved in the company.[23] Resolutions adopted by a management board without observing these reasonableness and fairness requirements may be annulled, and this may subsequently establish the liability of the managing directors based on principles of tort law.

Under Dutch law in most instances a director is considered to be an employee of the company, although the relationship between the company and its director can also be structured as a service agreement.[24] In particular, an agreement between the company and its director cannot be characterized as an employment agreement when no salary or remuneration is paid to the director or when the position of the director is held by a legal entity. If the relationship is in the form of an employment agreement, this agreement starts and ends in most cases with the appointment and resignation of the director. This means that there are two relationships between a director and the company: one is governed by company law and the other by employment law. It follows from section 7:611 DCC that a director has to act as a 'good' employee. Being 'a good employee' means acting in accordance with the principle of the protection of legitimate expectations, the principle of proportionality and the principle of fair play.[25] Therefore, from a dogmatic point of view, a violation of management duties leads to liability under section 2:9 DCC, whereas a violation of other duties leads to liability under section 6:74 DCC, which creates liability for breach of the (employment) contract. In practice, it may be difficult to characterize conflicts as related or not related to the actual management of the company.

With regard to listed companies, the Management and Supervision Act excludes that the legal relationship between a director and the company is regarded as an employment agreement. The purpose of this change is to prevent resigning directors from having a claim to severance payment under their employment agreement, which is not in accordance with best practice rules pursuant to the Dutch Corporate Governance Code. However, the measure has received some criticism in the legal literature and has been characterised as inefficient token legislation.[26]

3.1.2 External duty: refraining from tortious acts against third parties

A tort committed by a director will generally be considered as a tort of the company and no personal liability will result. [27]However, in exceptional situations, the dealings of the director will also be considered tortious and the director will be liable alongside the company. This 'secondary' liability will only kick in if the dealings of the director meet the 'higher' standard of 'serious personal reproach', developed in case law.

[23] DSC 18 February 1966, NJ 1966/208 (*Nederlandse Klokkenspel Vereniging*).
[24] Asser/Maeijer/Nieuwe Weme/Van Solinge 2009, nr. 425.
[25] Groene serie, art. 7:611 BW, aantekening 5.
[26] e.g. G.J.J. Heerma van Voss, 'De bestuurder geen werknemer meer?', *TijdscDSCift Recht en Arbeid,* 2010/3.
[27] Section 6:162 sub 1 DCC: 'A person who commits a tortious act (unlawful act) against another person that can be attributed to him, must repair the damage that this other person has suffered as a result thereof.'

In determining whether an act is tortious, the subjective and objective foreseeability of the effects of the

act play an important role, together with the specific circumstances of the case. In the following types of situation the courts have held a director liable for a tortious act:

- entering into obligations with a third party, whilst the director knew or should have known that the company would not be able to fulfil them;[28]
- knowingly frustrating creditors' claims;[29] and
- selective payment, frustrating a single creditor's claim and benefiting another, if damage for such creditor is foreseeable.[30]

An act of tort against a creditor often occurs in the vicinity of insolvency as the company will then not be able to meet its obligations.

3.1.3 External duty: drawing up proper accounts

Section 2:139 DCC stipulates that if the interim figures or the annual accounts misrepresent the condition of the company, the directors shall be liable to third parties for any loss suffered by them as a result thereof. Section 2:139 DCC is considered to be lex specialis in relation to general tort law. Liability is ´strict´ in a sense that the ´serious personal reproach´ need not be established. The injured party will bear the burden of proving the causal relationship between the loss and the misleading accounts. A director can exculpate himself if he cannot be blamed for the misleading accounts.

3.1.4 External duty: paying taxes and social security contributions

Under certain conditions, a director or a *de facto* director can be held liable towards authorities and institutions for not paying the company's taxes, social security contributions and pension premiums. This is the case if the non-payment is due to manifestly improper management by the director or the *de facto* director.[31]

3.1.5 External duty: actions before the company is duly incorporated and capital protection

To prevent liability a director must comply with certain regulations regarding incorporation and capital protection. According to section 2:93 DCC, before a company is incorporated, a director can perform legal acts in the name of the company, but he is jointly and severally liable for such acts until the company ratifies them. It follows from section 2:69 DCC that directors will be held jointly and severally liable even after incorporation until the company is registered with the chamber of commerce, the paid up share capital amounts to at least the minimum capital, and at least 25% of the issued share capital has been paid up.

[28] DSC 6 October 1989, NJ 1990, 286, m.nt. J.M.M. Maeijer (*Beklamel*).
[29] DSC 3 April 1992, NJ 1992, 411 (*Van Waning/Van der Vliet*); DSC 18 February 2000, NJ 2000, 295; JOR 2000/56 (*New Holland Belgium/Oosterhof*).
[30] DSC 12 June 1998, NJ 1998, 727; JOR 1998/107 (*Coral/Stalt*) and DSC 26 March 2010; JOR 2010/127.
[31] Section 36 Invorderingswet and Section 23 Coördinatiewet Sociale Verzekering and Section 23 Wet verplichte deelneming in een bedrijfstakspensioenfonds.

Acquisition by a company of its own shares and shares of its parent company are restricted under Dutch law.[32] For instance, a company cannot own more than half of its issued capital and the shares cannot be transferred without consideration. A transfer in breach of these provisions will be void and a director is jointly and severally liable for the damage incurred by the transferor.

3.1.6 Duties of a director of a listed entity: corporate governance code

The Corporate Governance Code, which intends to function as a form of self-regulation, partly regulates corporate governance within listed companies. Listed companies should either adhere to the principles set out in the Code or explain in their annual accounts why they deviate from it. Section II of the Code provides principles and best practices for management boards of listed entities and is divided in three into chapters.

The first chapter of Section II of the Corporate Governance Code contains the principles relating to the role of the management board to which directors ought to adhere. This role is to manage the company, which means, amongst other things, that the board is responsible for achieving the company's aims, implementing the strategy and associated risk profile, and considering corporate social responsibility issues that are relevant to the enterprise. The board has to comply with all relevant primary and secondary legislation, manage the risks associated with the company's activities and finance the company.

The second chapter of Section II contains principles and best practices which relate to the remuneration of directors. Compliance with these principles is mainly a responsibility of the supervisory board.

The third chapter of Section II contains principles and best practices which relate to conflicts of interest. The code provides that any conflict of interest or apparent conflict of interest between the company and the management board members shall be avoided. Decisions to enter into transactions, under which management board members would have conflicts of interest that are of material significance to the company and/or to the relevant management board member, require the approval of the supervisory board.

3.1.7 Duties of directors of a subsidiary

As stated before, section 2:11 DCC provides that liability incurred by a legal entity acting as a director will also be incurred jointly and severally by the directors of the legal entity.

Section 2:7 DCC provides for the possibility of the company to annul a legal act by the company which is contrary to its purpose as defined in its articles of association, provided that the third party involved was aware of could have been aware of this. It is particularly important whether the interests of the company are served by the performed legal act.[33]

[32] Sections 2:98, 2:98a and 2:98d DCC.
[33] DSC 20 September 1996, NJ 1997, 149 (Playland).

Although Dutch corporate law does not contain a separate set of rules for directors of a group company, it is generally held that the directors of a group company are bound by the overriding interests of the group, as articulated by the group directors. They are not expected to observe the interests of the group beyond the boundary where the interest of the group company is seriously harmed. An example of the tension between the interests of the group and the interests of the group company is where a group company is asked to provide collateral for group financing. Often a parent company will request a subsidiary to hold itself jointly and severally liable and to provide security for a loan which will be extended at the group-level. For the subsidiary's board

this poses the question to which extent it ought to cooperate with such a request and to which extent it is able to claim that the loan is actually beneficial for the company rather than the group. It is argued that a subsidiary providing security for a group loan shall in principle be an act in its own interest, unless the subsidiary is facing (or foresees) financial problems.[34]

3.2 Supervisory directors' duties

The articles of association can provide for a facultative board of supervisory directors, also referred to as a two-tier board. Under certain conditions, a large company is required by law to establish a board of supervisory directors. The duties of the supervisory board are described in Section 2:140 sub 2 DDC, which reads:

> "The duties of the supervisory board shall be the supervision of the policy of the management and the general course of affairs of the company and the enterprise connected therewith. It shall assist the management with advice. In the performance of their duties the members of the supervisory board shall be guided by the interest of the company and the enterprise connected therewith."

Unlike the board of directors, the supervisory board is not responsible for representing the company or for its day-to-day management. An exception exists in conflict-of-interest situations. The core duties of the supervisory directors can thus be described as two-fold: (1) supervision and (2) advice.[35] The DSC has recently held that article 2:140 of the DCC does not legally require the (members of the) supervisory board to act as an intermediary when there is a conflict between the board of directors and the shareholders of the company.[36]

The supervisory function of the supervisory board requires both a review of management policy in retrospect as well as the general supervision of the board of directors' long term future strategy. These duties include the supervision of the main features of the strategic policy, the general and financial risks, the administration and control systems, as well as the quality and continuity of the company's management. The duties of the supervisory board are not limited in scope to the activities of (the management board of) the legal entity of which the supervisory board is an organ, but extend to the company's subsidiaries as well.

The supervisory board has a veto right with regard to important decisions of the board of directors if this is required by law (which is the case under the mandatory two tier regime for big companies) or

[34] Asser 2-II* De naamloze en besloten vennootschap, 830 Concernfinanciering en doeloverschrijding.
[35] Asser/Maeijer/Nieuwe Weme/Van Solinge 2009, nr. 486.
[36] DSC 9 July 2010, LJN: BM0976.

when this is stipulated in the articles of association. Such can be the case, for example, when the board of directors proposes a merger or large acquisition.[37] Finally, the supervisory board has a special supervision duty in relation to the financial reporting of the company. If the continuity of the company is at stake, the supervisory board is required to intensify its supervisory efforts.[38]

3.3 Regulation of related-party transactions and corporate opportunities

A director has a conflict of interest in case he has a direct or indirect personal interest which conflicts with the interest of the company. In case a conflict of interest exists between the company and one or more of its directors, such a director is not to participate in discussions or decision making with regard to the subject the conflict of interest exists (section 2:129 DCC). In case no decision can be made as a result of this, the decision will be made by the supervisory board, or in case the company has no supervisory board, by the general meeting of shareholders.

3.4 To whom are the duties owed?

In general a director has to act in the interests of the company. As Dutch corporate law adheres to the stakeholder model, this does not only involve the interests of the shareholders. The dominant theory is that the corporate interest requires a weighing of the interests of the respective stakeholders, such as shareholders, employees and creditors. Due to the application of the stakeholder theory, it is important for directors to consider not only all different interests of stakeholders, but also to incorporate this in their decision-making process.[39] Dutch statutory law gives no guidance to directors on how to weigh the different interests. However, friction between the interests of the shareholders and the interests of the company occurs regularly in case law concerning (hostile) takeover bids and activist shareholders trying to change the strategy of the company. The Enterprise Chamber of the Amsterdam Court of Appeal is a special division for these corporate proceedings. The Enterprise Chamber decided in several cases that temporary defence mechanisms of the company are allowed when considered necessary for safeguarding the company's interest (and thus the interests of its stakeholders).[40] The standard for maintaining these temporary defence mechanisms is whether the director could reasonably consider the defence mechanism necessary and proportionate to continue the "status quo" of the company for a limited time and therefore prevent changes in management or strategy of the company without consultation of shareholders.[41]

Directors are obliged to provide the general meeting of shareholders with all information that it requires, unless this would be contrary to the 'material interests' of the company.[42] Neglecting this duty may lead to mismanagement proceedings at the Enterprise Chamber of the Amsterdam Court of Appeal.[43]

[37] Section 2:107a DCC.
[38] Asser/Maeijer/Nieuwe Weme/Van Solinge 2009, nr. 487.
[39] Asser/Maeijer/Nieuwe Weme/Van Solinge 2009, nr. 395-396.
[40] DSC 18 April 2003, NJ 2003, 286; JOR 2003/110 (RNA); OK 11 maart 1999, NJ 1999, 351; JOR 1999/89 (Breevast); OK 3 maart 1999, NJ 1999, 350; JOR 1999/87 (Gucci); OK 27 mei 1999, NJ 1999, 487; JOR 1999/121 (Gucci).
[41] DSC 18 April 2003, NJ 2003, 286; JOR 2003/110 (RNA).
[42] Section 2:107/217 lid 2 DCC.
[43] DSC 21 February 2003, NJ 2003, 182; JOR 2003/57 (HBG).

3.5 The director as a shareholder

Directors who make use of their voting powers as shareholders in the general meeting are subjected to the same provisions on voting rights as other shareholders. Under Dutch law, voting rights are attached to the shares.[44]

As any shareholder is allowed to act in his own interest (though within the limits that are set by the fact that there may be other shareholders who have their own interest and who have a claim to be treated with *bona fides*), the shareholder who is also director is in principle allowed to act as any other shareholder who is no director. Therefore, a director who holds all the shares may in fact be fully steered by himself acting as shareholder.

3.6 The time span of the duties

The duties of a director will last as long as the director holds office. It is conceivable that certain duties survive resignation, for instance the duty to return documents which belong to the companies´ records.

3.7 Application of duties to *de facto* directors

Under Dutch law, *de facto* directors are considered equivalent to actual directors with regard to liability. Aggrieved parties can bring an action against *de facto* directors based on tort.[45] In case of insolvency, *de facto* directors or so called “co-policy makers” are equally liable for the negative balance of the insolvent company based on section 2:138 DCC (see section 4.3).

[44] Section 2:117 DCC.
[45] See for example Rb. Utrecht 10 November 1999, JOR 2000/94; Hof Leeuwarden 21 april 2009, JIN 2009, 487, m.nt. Van 't Spijker (Bon Apetit).

4 LIABILITY FOR BREACH OF DUTY

A division can be made between internal and external liability. Within external liability a subdivision can be made between liability outside insolvency (general tort) and liability in the context of insolvency (2:138 DCC, considered to be *lex specialis* in relation to general tort law). These categories are, together with the internal liability of section 2:9 DCC, considered to be the main grounds for liability. Although these three grounds for liability have different connotations, it is increasingly argued in the legal literature that they have converged into the same standard of assessment.[46]

With regard to who bears the burden of proof when determining liability, Dutch law has a general rule that the party advancing a claim has the burden of proof with regard to the facts supporting this claim.[47] Under some conditions, Dutch law, either by statute or case law, establishes the presumption that statements are true. For example, within the scope of section 2:138 DCC, if a director fails to publish the annual accounts the mismanaged is established and is presumed to be an important cause of the insolvency of the company. Although the mismanagement is established the director does have the opportunity to rebut the presumption. Moreover, judges are allowed to disregard the main rule regarding the burden of proof if the principles of reasonableness and fairness require them to do so.

4.1 Internal liability: conditions for liability

A director who does not comply with his duty to properly manage the company can be held liable if he can be personally blamed and the fault is "sufficiently serious" (section 2:9 DCC).[48] This standard also applies to supervisory directors (section 2:149 DCC) and non-executive directors (section 2:9 DCC). The famous Dutch Staleman / van de Ven case demonstrates that all circumstances of the case are important when considering whether the blame is sufficiently serious. These circumstances include the nature of the activities of the company, the risks which generally result from this type of activity, the division of tasks within the board of directors and the knowledge that the director had or should have had at the time of the disputed action. From Dutch case law it also follows that liability is in principle established if a director acts contrary to provisions of the articles of association (and presumably also provisions) which aim to protect the interests of the company, although a director can exculpate himself by proving that he cannot be "sufficiently seriously" blamed.[49]

Tasks can be assigned to directors by law and through the articles of association. Each director is held responsible towards the legal person for a proper performance of his tasks. Unassigned tasks are considered to be tasks of each director. Moreover, every director is held responsible for the ordinary course of business. A director is held liable for improper management, unless proves that no "sufficiently serious" blame can be made with regard to the mismanagement (in view of the division of tasks) and he has not been negligent in taking measures to avert negative the consequences thereof.[50] No distinction in standard of care is made between directors with important positions on the board and other directors.

[46] D.A.M.H.W. Strik, Grondslagen bestuursaansprakelijkheid: een maatpak voor de Board Room, p. 55, Kluwer: 2010.
[47] Section 150 Rv.
[48] DSC 10 January 1997, NJ 1997, 360 (Staleman/van der Ven).
[49] DSC 29 November 2002, NJ 2003, 455 (Berghuizer Papierfabriek).
[50] Section 2:9 DCC.

Dutch law does not know an institution comparable to the business judgement rule. Dutch courts are however able to intervene in the management's core policy. This is best seen in the far reaching measures that the Enterprise Chamber of the Civil Court of Appeal of Amsterdam can take in the context of inquiry proceedings, in which shareholders can request the Enterprise Chamber to conduct an inquiry into the policy and conduct of business of a company. Examples of such measures are the power of the Enterprise Chamber to set aside decisions made by the management of the company and the power to appoint supervisory directors.[51]

4.2 External liability for tort: conditions for liability

Any person or legal entity which violates the rights of another person or legal entity or commits an act or omission contrary to statutory law or a rule of unwritten law can be held liable for the damage incurred by that other person or legal entity on the basis of tort law. A tort committed by a director will generally be considered as a tort of the company and no personal liability will result. [52] However, in exceptional situations, the dealings of the director will also be considered tortious and the director will be liable alongside the company. This 'secondary' liability will only kick in if the dealings of the director meet the 'higher' standard of 'serious personal reproach', developed in case law. Supervisory directors can be held liable on the basis of the same standard.[53]

A prerequisite for a tortious act is that the act can be attributed to the director in the sense that he can be seriously and personally reproached for it. A director can be reproached when he could have foreseen and prevented the damage, acting as could be expected from a normal and alert person. Furthermore, an act is only tortious if the duty which was violated was intended to protect the interests of the person who has sustained the damage.

Burden of proof

In principle, the person who claims that a tortious act has been committed has the burden of proving the conditions for liability. However, judges have the authority to deviate from this principle on grounds of reasonableness and fairness. With regard to directors' liability, the Dutch Supreme Court has done so in two instances.[54] Both cases concerned directors of a company who were at the same time the sole shareholders of the company. As a general rule, the Supreme Court held that there are cases in which it will be evident that the person who has total control over the company will have to bear the burden of proof.[55]

4.3 External liability for bankruptcy: conditions for liability

The dominant opinion in the Dutch legal literature is that section 2:138 DCC can be regarded as a special form of tort.[56] A director can be held liable by a liquidator for the amount by which the debts of

[51] For more information: Timmerman, De rechter en de toetsing van ondernemingsbeleid, OR 2002/193.
[52] Section 6:162 sub 1 DCC: 'A person who commits a tortious act (unlawful act) against another person that can be attributed to him, must repair the damage that this other person has suffered as a result thereof.'
[53] See, e.g., Rechtbank Utrecht 12 December 2007, JOR 2008/10 (Ceteco).
[54] See de Groot, Bestuurdersaansprakelijkheid, p. 57.
[55] DSC 10 June 2004, NJ 1994, 766.
[56] Asser 2009, nr. 454.

the company exceeds the assets after liquidation, if (i) he has acted manifestly improperly and (ii) it is plausible that his conduct was a major causal factor for the bankruptcy. The same standard applies to supervisory directors (section 2:149 DCC). Dutch statutory law does not provide for a definition of manifestly improper conduct, but the DSC has held that this means that - given the circumstances at hand - no adequate director would have acted in such a way. The law furthermore provides for two situations in which manifestly improper conduct is irrefutably presumed, namely when the board of directors (i) has not kept proper books or (ii) did not file the annual accounts with the chamber of commerce. If this is the case, the law provides for the non-rebuttable presumption that the management board has acted manifestly improperly, and the rebuttable presumption that this was an important cause of the bankruptcy.

The liquidator can only institute a claim based on section 2:138 DCC for improper conduct that occurred during the three years preceding the bankruptcy. A majority of claims under section 2:138 DCC is brought by the liquidator on the basis that the company did not file its annual accounts in time, even though this may have nothing to do with the bankruptcy of the company.[57] For this reason, the statutory presumption that is triggered by not filing the annual accounts in time has been criticised by some legal authors.[58]

Other examples of manifestly improper conduct include: making decisions with far-reaching financial consequences without proper preparation,[59] neglecting credit management, paying a due and payable debt to one of the company's group companies,[60] and acting contrary to the purpose of the company as set out in the articles of association.[61]

Burden of proof

In case of an act by the management board which triggers a statutory presumption, the manifestly improper conduct will be irrefutably presumed. The rebuttable presumption that such manifestly improper conduct was an important cause of the bankruptcy can be contested by the director.

Aside from the two statutory presumptions mentioned above, in principle the burden of proof for manifestly improper conduct will be on the liquidator and not the directors. As it has to be shown that improper conduct has been *manifest*, this test can be considered a rather high standard. To prove that it is plausible that such conduct is an important cause for the bankruptcy is a lighter test as only the *plausibility* of the causal link between the improper conduct and the bankruptcy has to be proved.

4.4 External liability for failing to draw up proper accounts: conditions for liability

[57] In 53 of the 72 published cases since 2000 which are based on 2:138/248 DCC a statutory presumption was triggered, see Ph.W. Schreurs, *De thermometer van kennelijk onbehoorlijk bestuurs. Een onderzoek naar de effectiviteit van art. 2:248/138, lid 1 en 2*, TvI 2011/11.

[58] See B.J. de Jong, M.P. Nieuwe Weme, *Publicatie van de jaarrekening*, dl. 91 Serie uitgaven vanwege het Van der Heijden Instituut, Deventer: Kluwer 2006, p. 118. Also see J.B. Huizink, *De jaarrekening en de 'kleine onderneming'*, Tijdschrift voor jaarrekeningenrecht, 2008/6, p. 128 e.v.

[59] District Court Amsterdam 21 March 2007, JOR 2007, 113.

[60] DSC 30 May 1997, NJ 1997, 663.

[61] DSC 2 November 1984, NJ 1985, 446. For more examples see de Groot, Bestuurdersaansprakelijkheid, p. 108 and 109.

Misleading annual and interim accounts have been a hot topic in recent years. Section 2:139 DCC stipulates that if the interim figures or the annual accounts misrepresent the condition of the company, the directors shall be liable to third parties for any loss suffered as a result thereof. Section 2:150 DCC stipulates that supervisory directors can be held liable for misleading annual accounts as well, but not for misleading interim accounts. The ratio behind this is that in case of the annual accounts the supervisory directors can rely on an audit certificate.[62] A claim based on this section of the DCC can also be brought by shareholders of the company.[63]

Burden of proof

A third party who holds a director liable for misrepresentation does not need to prove that there was an intention to misrepresent the accounts. The claimant merely needs to prove that the accounts misrepresented the condition of the company and that he suffered a loss as a result thereof. Directors and supervisory directors can exculpate themselves if they can show that they did not sign the annual accounts or interim figures because of the misleading information contained therein. In legal literature it is argued that for misrepresentation it has to be claimed and proven, that items which are of importance for judging the general financial position of the company, were not included or wrongly reflected in the accounts.[64] Once this has been established, the claimant needs to show a causal link between the misrepresentation and the loss.

4.5 External liability for taxes and social security premiums: conditions for liability

A public authority to which a company owes tax or social security contributions can hold a director liable on two grounds: an ordinary civil action that is also available to other creditors, such as tort, or an action based on one of the liability clauses provided in specific legislation.[65] Directors can be held liable if non-payment was due to manifestly improper management by the company's director(s). This liability is not limited to the debt, but includes fines, interest and costs of proceedings. In principle, supervisory directors are not liable for the non-payment of taxes and social security premiums by the company. However, they can be held liable if they acted as actual policymakers in this context.[66]

Burden of proof

If a company is not able to pay its tax, social security or pension obligations, it is required to notify the relevant authority. Each director is under the obligation to ensure that the company makes the aforementioned notification. If the director notifies the authority in time, the burden of proof lies with the authority to show manifestly improper management, and the causal link between the improper conduct and the failure to pay the tax or social securities obligations. If, however, the notification was not given in time, the director is presumed to be liable. The burden is on the director to prove that the non-payment of the amount owed was not due to manifestly improper management, and the relevant director will also have to prove that he cannot be blamed for the failure to properly notify the authority.

[62] See Kamerstukken II, MvA, 15 304, nr. 6, p. 38.
[63] District Court Amsterdam 25 June 2008, RO 2008, 73. See also Asser/Maeijer/Van Soling/Nieuwe Weme 2009, nr. 470.
[64] D. Strik, Grondslagen bestuursaansprakelijkheid, p. 153.
[65] Sections 22-23 Wet Bpf, 57-60 Wfsv and 36-36a IW 1990.
[66] H. de Groot, *Bestuurdersaansprakelijkheid* (Deventer: Kluwer 2011), p. 170.

The provisions seem to be aimed largely at whether there has been proper notification. For that reason they have been the subject of criticism.[67]

4.6 External liability before incorporation of the company and breach of capital requirements: conditions for liability

According to section 2:93 DCC, before a company is incorporated, directors can perform legal acts in the name of the company. However, they are jointly and severally liable for legal acts until the company ratifies them after its incorporation. Furthermore, it follows from section 2:69 DCC that directors will be held jointly and severally liable even after incorporation until (i) the company is registered with the chamber of commerce; (ii) the paid up share capital amounts to at least the minimum capital; and (iii) at least 25% of the issued share capital has been paid up. This liability applies without further requirements. These provisions are usually not very relevant for supervisory directors as they ordinarily do not perform legal acts in the name of the company before incorporation. However, if a (future) supervisory director does act on behalf of the company before incorporation (e.g., because of a conflict of interest situation on the part of a director), section 2:93 DCC would apply to him/her as well as section 2:93 DCC applies to *any* person who acts on behalf of the company.

After fulfilling the prerequisites mentioned in the previous paragraph and ratifying the directors' actions, if a company cannot fulfil the obligations entered into by the director and the director knew or should have known this, he or she will be held liable for any loss suffered as a result thereof. Such knowledge will be assumed if the company is declared bankrupt within one year after incorporation.[68]

4.7 Exemptions and limitations

4.7.1 Internal liability: exemptions from liability

The fiduciary duty of 2:9 DCC is a collective one. This means that if one director is liable to the company due to the improper performance of his task, the other directors will be too. However, if the management board consists of more than one director, directors can individually exculpate themselves if two conditions are met:

1. The individual director cannot be blamed for the improper performance inter alia because of the tasks which have been attributed to other directors; and
2. Such director has taken measures, or has not been negligent in not taking measures, to mitigate the negative consequences of the improper performance.

An example for exculpation would be a director who was on a holiday when the improper performance occurred and who tried to mitigate the consequences of it after his return.

A director can also exculpate himself if the task is not borne collectively (which is the general rule) but allocated to a specific director and does not belong to the area of the defendant director. The Act of Management and Supervision has amended section 2:9 DCC so that it is made clear that directors are

[67] Annotation Timmerman HR 16 March 2007, NJ 2007, 321.
[68] Section 2:93 sub 3 DCC.

responsible for all tasks which are not attributed to other directors by law or the articles of association. Therefore, such an exculpation can only be held against the company if the division of tasks has its basis in statutory law or the articles of association.[69] Furthermore section 2:9 sub 2 DCC provides that each director shall be responsible for the general course of business, which is a task that cannot be delegated.

In principle, a company cannot indemnify the director against liability contractually or in its articles of association for 'seriously imputable faults'. It is generally thought that such an indemnification clause cannot be upheld as it is contrary to statutory law (section 2:9 DCC) and therefore void in accordance with section 3:40 DCC.[70] It is considered permissible for the company to undertake to pay the legal costs that may be incurred in relation to internal liability. However, once the director has actually been found liable, such costs will have to be repaid.

Internally, a director can be discharged for his management in the preceding year by the general meeting of shareholders. A discharge is limited to facts and circumstances available from the annual accounts and cannot be relied on by directors who provided incorrect information in the annual accounts.[71] Furthermore, a discharge is given by the meeting of shareholders as a body of the company and therefore does not prevent an individual shareholder nor a bankruptcy trustee from instituting proceedings against a director.[72]

4.7.2 Tort: exemptions from liability

The tortious nature of an act can be justified on certain grounds. Grounds for justification accepted under Dutch law are borrowed from criminal law. They are: force majeure, an emergency situation, legal authorisation and an administrative order.

4.8 Insurance against liability

Insurance for directors and supervisors ("D/S-insurance") is allowed by Dutch law and is widely available. Insurers collectively created an insurance pool which provides for a risk distribution for liabilities covered by such insurances. According to an investigation in 2004, about 60% of the directors have a D/S-insurance. The insurance itself is usually entered into by the company on behalf of the director pursuant to a clause in the employment agreement. In principle, any type of liability risk can be insured, but depending on the insurance policy there may be limitations and a deductible. Non-domestic insurers are generally not allowed to enter into insurance agreements without prior consent of the Dutch Central Bank.

[69] J.B. Huizink, 'Artikel 2:9, enkele observaties', *Hoe verder met collegiaal bestuur in Nederland?*, p. 8, Kluwer, 2011.
[70] G.P. Oosterhoff, 'Kruiselingse vrijwaring van bestuurders', Ondernemingsrecht 2010, 8, p. 340 a.f.
[71] DSC 25 June 2010, LJN B; 2332, NJ 2010, 373.
[72] See section 2:138 sub 8 DCC.

4.9 Consequences of liability

A director who is held liable is jointly and severally liable for the damages which are related to the event giving rise to the liability, which, also having regard to the nature of the liability and of the damage, can be attributed to him as a result of such event.[73]

4.10 Duration of liability

Liability of directors for their actions exists for five years, starting with the day on which the claimant becomes aware of the damage as well as the identity of the persons who are to be held liable. After five years the claim is extinguished.[74]

[73] Section 6:98 DCC.
[74] Section 3:310 DCC.

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 The meaning of 'vicinity of insolvency'

At the request of the company, or a creditor, a company will be declared bankrupt by a judge in the Netherlands the company it has stopped paying its debts and has at least two creditors, one of whom should have a claim which is due and payable.[75] As bankruptcy will not occur automatically, the company will become insolvent before it becomes bankrupt. The 'vicinity of insolvency' as such is not a concept in Dutch statutory law, but as further explained in the next paragraphs there are a number of provisions which apply near bankruptcy. In Dutch legal literature the concept of the 'twilight zone' before bankruptcy has been introduced, which starts with insolvency and ends with bankruptcy.

5.2 Change of existing duties

Dutch law adheres to the stakeholder theory and thus a director should at all times consider the creditors' interests. Near insolvency the duties of a director might shift in the sense that creditors' interests will become more important in determining the interests of the company. Although in theory shareholders are the residual claimants of the company, in practice it is rare for a shareholder to receive a sum out of the company's estate. Therefore, it is natural that the focus of the company would shift to the creditors. Although not specifically stated in Dutch law, this shift in interest becomes clear when looking at a number of statutory provisions which apply near bankruptcy, for example the presumption regarding manifestly improper management by a director who does not file annual accounts or keep proper books in the three years preceding bankruptcy, as set out in section 4 of this report.

5.3 Newly arising duties

Section 2:138 DCC sets out the main rules for liability in bankruptcy. Subsection 1 stipulates that a director can be held liable for the amount of the debts which cannot be satisfied from the assets if (i) he has performed his duties manifestly improperly and (ii) this was an important cause of the bankruptcy. As discussed above, in some cases the manifestly improper performance of the director's duties is presumed. The statutory presumption concerns (i) the duty to keep proper books and (ii) the duty to file the annual accounts with the chamber of commerce.[76] The duties mentioned in section 2:138 apply *mutatis mutandis* to *de facto* directors.[77] According to section 2:149 DCC, the duties set out in section 2:138 DCC also apply to supervisory directors.

[75] Section 1 Bankruptcy Act ("**BA**").
[76] Sections 2:10 and 2:394 DCC, respectively.
[77] DSC 23 November 2001, NJ 2002, 95, m.nt. J.M.M. Maeijer.

A director can be held liable if he enters into obligations while he knew or should have known that the company will not be able to perform the obligations and the company does not provide any other recourse for the creditor.[78] This rule contains two economic tests: one concerning the liquidity of the company and one concerning its solvency. If both tests fail, the company is considered to be *factually insolvent*. In this case the activities of the company have to be discontinued. The rationale behind this is that when the company becomes factually insolvent it needs to shift its focus from the stakeholders' interests to the interests of the joint creditors.[79] In addition, directors may face liability in the vicinity of insolvency for treating the company's creditors unequally as a result of making selective payments to some creditors if damage for such creditor is foreseeable.[80]

[78] DSC 6 January 1989, NJ 1990, 286 (*Beklamel*).
[79] A.P.G. Gielen and C. Bijl, 'Pompen of verzuipen? Bestuurders in de gevarenzone: ken uw getallen', Onderneming en Financiering 2011 (19) 4, p. 82.
[80] DSC 12 June 1998, NJ 1998, 727; JOR 1998/107 (*Coral/Stalt*) and DSC 26 March 2010; JOR 2010/127.

6 Enforcement of Duties

6.1 Who has standing to sue

6.1.1 The company as plaintiff

Only the company, represented by the board of directors, has standing to sue when a director has breached his duties towards the company. The general meeting cannot bring an action on behalf of the company. Naturally, as a consequence, actions by the company against its current directors are extremely rare. In the cases in which directors are sued relating to a breach of their fiduciary duties, the directors have often been either permanently or temporarily replaced by other persons. The most obvious way for the general meeting of shareholders to achieve this is to either suspend or remove such directors and appoint other directors who will institute a claim for damages on behalf of the company. Also, in case of a possible claim by the company against a current director, the relevant director has a conflict of interest within the meaning of section 2:129 sub 6 DCC.

6.1.2 The shareholders as plaintiffs

6.1.2.1 In their own name

Under Dutch law it is generally accepted that shareholders can only sue directors on the basis of tort law. The internal duty to manage the company properly is owed to the company; an action based on this duty can only be brought by the company or, in case of insolvency, the liquidator.

Those who are authorised to do so can request the Enterprise Chamber of the Civil Court of Appeal of Amsterdam to conduct an inquiry into the policy and conduct of business of a company. The inquiry proceedings are regulated in section 2:344 DCC et seq. In case the company has a subscribed capital of less than EUR 22,500,000 shareholders or holders of depositary receipts can make such a request if they represent 10% or more of the issued capital or are entitled to an amount of shares or depository receipts with a nominal value of EUR 250,000 or more. In case the company has a subscribed capital of more than EUR 22,500,000 shareholders or holders of depositary receipts can make such a request if they represent 1% or more of the issued capital or, in case it concerns a listed company, their shares or depositary receipts represent a value of more than EUR 20,000,000. The Enterprise Chamber will commence an inquiry if there are well-founded reasons to doubt the appropriateness of the conduct of business of the company. It will appoint investigators who are entitled to request all necessary information. When an immediate remedy is required in light of the condition of the company or in the interest of the inquiry, the Enterprise Chamber may at any stage of the proceedings order such remedy for the duration of the proceedings. This has proven to be a rather powerful instrument. In the past, it has for instance lead to the suspension of directors, appointment of supervisory directors with special powers, ordering of a standstill, suspension of resolutions of the management board and suspension of voting rights.[81] The inquiry proceedings cannot be used to claim damages directly from a misbehaving director. However, once the Enterprise Chamber has established that there was in fact

[81] See, Asser/Maeijer/Van Solinge & Nieuwe Weme 2-II* 2009, pp. 931 et seq.

mismanagement by the board, this decision can be used in later civil proceedings to help establish liability.[82]

If as a result of the inquiry, misconduct or mismanagement is established, the Enterprise Chamber may issue orders such as the suspension or termination of a board decision, the temporary appointment of one or more directors, or even the dissolution of the legal entity (section 2:356 DCC). In Dutch corporate practice the inquiry proceedings are popular due to the Enterprise Chamber's ability to act relatively quickly and its flexibility to remedy a situation in which the conduct of business of the company is not appropriate.

6.1.2.2 In the name of the company ('derivative action')

A derivative action by shareholders is not possible under Dutch law. There are several grounds that justify not having a derivative action. Kroeze has made a distinction between three types of argument. The first line of argument is related to the undesirable effects of derivative actions. In particular, a derivative action would disturb the priority of claims in insolvency. This would be the case in relation to shareholders and external creditors, as well as amongst shareholders themselves. Secondly, there is an argument to be made from a formal-legal perspective, in that the distinction between the legal subjectivity of the shareholders and the legal entity should be strictly maintained. Finally, the nature of the damage should be taken into consideration. As a derivative action is by definition based on damages suffered indirectly, there are problems with establishing causality and the principle of relativity.[83]

6.1.3 Liquidator as plaintiff

A trustee in bankruptcy can make use of all three main grounds for suing a director: the fiduciary duty to manage the company properly pursuant to section 2:9 DCC, liability in bankruptcy pursuant to section 2:138 DCC, and an action on behalf of the joint creditors based on tort pursuant to section 6:162 DCC. The action on behalf of the joint creditors based on tort is also referred to as the Peeters/Gatzen-claim, based on the landmark case of Peeters v. Gatzen.[84] The liquidator usually uses a combination of these grounds.

6.2 Criminal and administrative sanctions

Under Dutch law, both natural persons and legal entities can commit crimes. The following persons and entities can be prosecuted when a criminal offence has been committed by a legal entity: the legal entity, the persons who performed the act, and the *de facto* directors.[85]

For criminal liability to arise pursuant to the Dutch Penal Code ("**DPC**"), it is not necessary that the director was involved in the actual conduct of the offence. General knowledge of criminal acts being

[82] See, W.D. de Boer, 'Tussen wanbeleid, kostenverhaal en aansprakelijkheid, V&O 2003/4, pp. 71-73.
[83] M.J. Kroeze, *Afgeleide Schade en Afgeleide Actie* (Deventer: Kluwer 2004), pp. 37 et seq.
[84] DSC 14 January 1983, NJ 1983, 597 (Peeters q.q./Gatzen). The Peeters/Gatzen-claim does not provide an independent ground for liability, but grants the liquidator in insolvency standing to enforce the tort claim (section 6:162 DCC) on behalf of the joint creditors.
[85] Section 51 Dutch Penal Code.

committed by the legal entity, followed by a lack of adequate response by the relevant director, is sufficient. The following offences can be categorised as specific offences of directors:

- Filing and publishing a false statement: this offence can be committed by a director who intentionally discloses or allows to be disclosed to the public a false statement, balance sheet, profit and loss account, statement of income and expenditure or false explanations pertaining to such documents (section 336 of the DPC).
- Activities contrary to any valid provisions of the articles of association or the by-laws: this offence can be committed by a director who has cooperated in or has granted permission for any activity contrary to the articles or by-laws, as a result of which the legal entity suffers a serious harm (section 347 of the DPC).
- Voluntary arrangement secretly favouring a creditor: offence of a director of a debtor company who concludes an agreement with a creditor pursuant to which the creditor will receive a special benefit if he agrees to a voluntary arrangement (section 345 paragraph 1 and 2 of the DPC).
- Culpable bankruptcy: this offence can be committed by a director of a N.V. which has been adjudged bankrupt:
    - i. where the director has cooperated in or has granted permission for any activity contrary to a valid provision of the articles of association or the by-laws to which activity the losses incurred by that legal entity can be wholly or largely attributed;
    - ii. where such person, with the object of delaying the bankruptcy of the legal entity, knowing that bankruptcy could not be avoided, has cooperated in the borrowing of money on onerous terms or has granted permission for such borrowing; and
    - iii. where he bears responsibility for non-compliance with a number of legal record or bookkeeping requirements.

In criminal law, a possible sanction is the prohibition of an individual from exercising his or her profession. In theory, this sanction could also be imposed on directors. However, there are no documented cases in which this has happened. The Dutch Minister of Justice has urged the courts to employ this sanction more often.[86] Previous governments also considered the implementation of a director disqualification mechanism under civil law. However, such a law is not expected to be adopted any time soon.

[86] See, D.R. Doorenbos, 'Het bestuursverbod', *Ondernemingsrecht* 2008/124.

7 CONFLICT OF LAWS

7.1 Company law

Dutch corporate law follows the incorporation theory (section 1:10 paragraph 2 DCC and section 10:118 DCC). The applicable law can be found pursuant to four possible regimes: the European Insolvency Regulation ("EIR"), the Rome I Regulation ("Rome I"), the Rome II Regulation ("Rome II"), and provisions of Dutch national law.

Section 2:119 sub d DCC stipulates that the liability of directors is governed by the law which governs the company. Thus, the internal liability of a director of a Dutch company (on the basis of sections 2:9 and 6:162 DCC) is governed by Dutch law.

7.2 Tort law

According to the prevailing opinion in the legal literature and case law, the external liability of directors to third parties on the basis of tort is classified as tort law for purposes of private international law.[87] Section 10:159 DCC applies the provisions of Rome II to obligations which can be characterised as tort, even though they fall outside the scope of Rome II. Hence, the main rule is that the claim is governed by the law of the country in which the damage occurs, irrespective of the country of incorporation. If the damage occurs in another country due to an act of tort by a director of a Dutch company, the law of that country would be applicable according to Dutch private international law.

7.3 Special duties in the vicinity of insolvency

Section 4 EIR provides that the law applicable to insolvency proceedings and their effects shall be that of the Member State within the territory of which such proceedings are opened (*lex concursus*). A point of discussion in the Dutch legal literature is whether a claim on the basis of section 2:138 DCC can be classified either as a claim in company law (since it is included in book 2 DCC) or as part of the insolvency proceedings by analogy with the Gourdain/Nadler citerium.[88] The latter position would have the consequence that if the insolvency proceedings are in the Netherlands, section 2:138 DCC[89] would be applicable, regardless of whether the company is a Dutch or a foreign undertaking. If, on the other hand, the company had been declared insolvent in a foreign country, section 2:138 DCC would not be applicable, even if it was a Dutch company. In national Dutch law this area is dealt with by section 10:121 sub 1 DCC, which provides that liability of directors in bankruptcy, pursuant to sections 2:138 and 2:149 DCC, is applicable to a corporation which is governed by foreign law and subject to

[87] N.W.A. Tollenaar, 'Bestuurdersaansprakelijkheid en IPR (II)', *TFZI* 2009/7, p. 206. See also Hof Leeuwarden 11 juni 2008, JOR 2009, 20 m.nt Veder (Essent/Jahani).
[88] See for an overview of this discussion Lennarts, 'Toepassing van art. 2:248 BW en art. 5 WCC na inwerkingtreding van de Europese Insolventieverordening', *TvI* 2001/178. 'Gourdain/Nadler' refers to the case of Henri Gourdain v. Franz Nadler, ECJ 133/78.
[89] Or section 2:248 DCC in cases involving the private company (BV).

Dutch corporation tax if it is declared bankrupt in the Netherlands. This rule is still relevant in cross border situations outside of the EU. In Dutch law it is uncertain whether an action on behalf of the joint creditors against a director on the basis of tort (*Peeters/Gatzen-claim*) should be considered part of the insolvency proceedings or part of Rome II proceedings.[90]

[90] S.M. van der Braak, 'Het IPR-vennootschapsrecht en boek 10 BW: een nadere toelichting', MvV 2010, 7/8, p. 207. , also see Court The Hague 21 December 2011, JOR 2012/131, r.o. 3.4.

LSE Enterprise

Directors' Duties and Liability in Poland

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CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in Poland

Company law in Poland has its primary source in the Code of Commercial Companies of 15 September 2000 (CCC).[1] The Polish legal system follows the principle of unity of civil law, therefore, Polish commercial law is not treated as a separate branch of law, but is rather considered to be a part of private law (civil law).[2] A manifestation of this principle is provided in Art. 2 CCC which states that the regulations of the Polish Civil Code apply to company law. Civil law provisions should be applied directly, unless the legal nature of the relation requires an application of the Civil Code regulations *mutatis mutandis*. Additional regulations can be found in the law of capital market which may contain specific rules governing public joint-stock companies. Also the Best Practices Code[3] adopted by the Warsaw Stock Exchange for the first time in 2002 (last amendments made on October 19, 2011), provides soft law regulations for publicly listed companies and members of their governing bodies.

1.2 Corporate landscape in Poland

The Code of Commercial Companies provides a comprehensive regulation for all types of partnerships and companies existing under the Polish law as well as mergers, divisions and transformations.[4] Historically, Polish company law is strongly rooted in the German tradition (the predecessor of CCC 2000, the Commercial Code of 1934 followed the German company laws).[5] It should be noted that due to its petrifaction during the communist regime, Polish company law suffered a fifty year gap in development and regained its full significance only after the introduction of the free market economy. Although the provisions of Commercial Code were never abolished by the communist regime, there was merely no private ownership that would allow the Commercial Code to be applied. The regulations eventually found their way back into the business relations that formed after 1989 and were used until the introduction of the Code of Commercial Companies. Polish company law provides for four types of partnership: registered partnership (*spółka jawna*), professional partnership (*spółka partnerska*), limited partnership (*spółka komandytowa*) and limited joint-stock partnership (*spółka komandytowo-akcyjna*). There are two types of capital companies available to the investors: limited liability company (*spółka z ograniczoną odpowiedzialnością*) as well as joint-stock company (*spółka akcyjna*). A joint-stock company may have two forms: listed (*publiczna*) and non-listed (*prywatna*). The latter is regulated only by CCC provisions. On July 29, 2005 Polish Parliament adopted three acts constituting the core of the capital market law: the Act on

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[1] Dz. U. No. 94, Pos. 1037.
[2] S. Włodyka [in:] S. Włodyka, *System Prawa Handlowego*, vol. 2A, Warsaw 2006, p. 12; S. Sołtysiński [in:] S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. I, Warszawa 2005, p. 18.
[3] Dobre Praktyki Spółek Notowanych na GPW (Corporate Governance Code) amended on 19 October 2011, [in:] force since 1 January 2012.
[44] The only exception provided for in the Civil Code is a regulation of Partnership of Civil Law (Art. 860-875 CC). Silent partnership in Poland is not regulated by any provisions of law. Both these forms of partnership are considered contracts regarding the ways of settlement between the partners.
[5] K. Oplustil, A. Radwan, [in:] Ch. Jessel-Holst, R. Kulms (red.), *Private Law in Eastern Europe. Autonomous Developments or Legal Transplants?*, Tübingen 2010, p. 448; S. Sołtysiński, S. *Sources of foreign inspiration in the draft of the Polish Company Law (1999)* [in:] Baums, T. Hopt, K.J. Horn, N. (eds.) *Corporations, Capital Markets and Business in the Law*, Kluwer Law International 2000, p. 533; S. Sołtysiński, *Transfer of Legal Systems as seen by the "Import Countries": A View from Warsaw* [in:] Drobnig, U. Hopt, K.J. Kötz, H. Mestmäcker, E.J: (eds.), *Systemtransformation in Mittel und Osteuropa und ihre Folgen für Banken, Börsen und Kreditsicherheiten* (Tübingen Mohr Siebeck 1998), pp. 70–72; S. Włodyka [in:] S. Włodyka, *System Prawa Handlowego*, vol. 2A, Warsaw 2006, p. 8.

Trading in Financial Instruments,[6] the Act on Capital Market Supervision[7] and the Act on Public Offering, Conditions Governing the Introduction of Financial Instruments to Organized Trading, and Public Companies.[8] As defined in the Act on Public Offering, the public company is a joint-stock company in which at least one share is dematerialised.[9] A listed joint-stock company is subject to growing number of regulations within the CCC and the rules of the acts on capital market.

1.3 The board of a Polish company

The structure of the Polish joint-stock company board is based on the two-tier system, typical for German law. A member of the management board cannot be at the same time a member of the supervisory board (art. 387 § 1 CCC). Pursuant to Article 368 § 1 CCC, the management board has the right and duty to conduct the company's affairs and to represent the company. There is a presumption of management board competences to conduct the company's business in case there are doubts which body has the prerogative to decide about certain matters.[10]

Further in this study we will refer to the members of this governing body as either members of the management board, managers or directors. The management board has to be composed of one or more members. The exact number (or at least the minimum or maximum number of members) needs to be specified in the provisions of the company's articles of association. The supervisory board has the right and duty to exercise permanent supervision over the company's activities in all aspects of its business (art. 382 § 1 CCC). The general assembly (shareholders' meeting) and the supervisory board may not, however, give the management board any binding instructions with respect to the management of the affairs of the company (art. 375^1 CCC).[11] Due to the typical existing ownership structure, dominated by concentrated shareholding in Polish companies, members of the management board are *de facto* strongly dependent on the majority shareholder (usually another legal entity, mostly controlling company).[12]

Even though there is a distinction between companies in which stock is being publicly traded and private companies, the same rules concerning the directors' duties and liabilities apply. Also the provisions concerning the limited liability company and joint-stock company are fairly similar.

No statutory regulations address the liability of the board of directors as a governing body of a company. The directors' liability is individual, although in case of a contribution to a damage by several members of the board, their liability will be joint and several.

[6] Dz. U. No. 183, Pos. 1538.
[7] Dz. U. No. 183, Pos. 1537.
[8] Dz. U. No. 184, Pos. 1539.
[9] The legal doctrine justifiably criticizes this technical criterion to divide the joint-stock company. K. Grabowski, *Dyrektywa o niektórych prawach akcjonariuszy i jej konsekwencje dla spółek publicznych*, HUK 2008, No. 4, p. 536.
[10] S. Sołtysiński [in:] S. Sołtysiński, *System Prawa Prywatnego. Prawo spółek kapitałowych*, vol. 17B, p. 471.
[11] This rule is not applicable to the management board of a limited liability company, see S. Sołtysiński [in:] S. Sołtysiński, *System Prawa Prywatnego. Prawo spółek kapitałowych*, vol. 17B, p. 471.
[12] See also D. Wajda, *Problemy związane z uczestnictwem akcjonariuszy mniejszościowych w walnych zgromadzeniach*, PPH 2006, No. 7, p. 43; K. Oplustil, A. Radwan, [in:] Ch. Jessel-Holst, R. Kulms (red.), *Private Law in Eastern Europe. Autonomous Developments or Legal Transplants?*, Tübingen 2010, p. 474.

2 The concept of 'company director' in Poland

2.1 De iure directors

2.1.1 Requirements to become a *de iure* director

Directors are appointed or dismissed by the supervisory board (art. 368 § 4 CCC). However, the provisions of articles of association may grant an individual right to appoint a certain number of the management board members to a shareholder (as an individual right)[13] or even to third parties (corporate relationship). The content of art. 370 § 1 CCC leads to a conclusion that the legislator distinguishes between the nomination relation and the employment relation based on a private law contract, especially employment contract. The private law contract may be concluded in addition to the nomination relation (however it is not obligatory). The managers may have a dual relationship with the company, as they may also enter into an employment contract (employment relationship).[14] The amount of remuneration is to be set by the supervisory board, unless the articles of association provide otherwise (art. 378 CCC).

Only *de iure* directors of commercial companies can be held liable for actions or inaction that violate the law and cause damage to the company, art. 483 CCC. However, the regulations of the Civil Code contain a broad general clause in regards to tort liability. It allows for liability of any person who causes damages (art. 415 CC). By contrast pursuing a claim under CCC provisions does not require the claimant to prove director's fault, as art. 483 CCC establishes a presumption of director's fault. A claimant who files a law suit based on art. 415 CC would have to prove not only existing damage and a causal link, but also the fault (see analysis below).

Polish law does not provide any specific arrangements for the liability of directors in companies which belong to the group of companies.[15]

2.1.2 Who can be *de iure* director

Under art. 18 § 1 CCC, only a natural person who enjoys full capacity to effect acts in law[16] may serve as a member of the management board, the supervisory board, the audit committee or as a liquidator. Polish law does not provide any exceptions from this rule,[17] although one should consider the possibility of the company entering into the contract for management of the dependant company,

[13] Art. 354 § 1 CCC.
[14] S. Sołtysiński [in:] S. Sołtysiński, *System Prawa Prywatnego. Prawo spółek kapitałowych*, vol. 17B, p. 490.
[15] According to the current project that is designed to regulate the groups of companies provides for a possibility to limit the liability of a director for the damages caused to the company, as long as the director acts in interest of the group of companies (art. 21).
[16] Art. 11 of the Civil Code provides for a regulation of capacity to effect acts in law.
[17] A. Szumański [in:] S. Sołtysiński, *System Prawa Prywatnego. Prawo spółek kapitałowych*, Warszawa 2010, vol. 17A, p. 463.

according to art. 7 of CCC.[18] Hence, it is impossible under Polish law for a legal person to become a director in any capital company. In general, there are no specific requirements concerning eligibility to become a member of the management board (nationality, citizenship, residence, or age of the director are not relevant).[19] Directors can be recruited from among shareholders of the company, but there is no legal requirement for them to own the company's stock.[20] A person who acts as a member of management board cannot become a member of the supervisory board (art. 387 § 1).

A person who has been sentenced under a final and non-appealable sentence for the crimes set out in the provisions of chapters XXXIII through XXXVII of the Penal Code, concerning crimes against protection of information, credibility of documents, crimes against property as well as crimes against economic, monetary, securities "circulation", may not serve as a member of the management board, supervisory board, audit committee or as a liquidator (art. 18 § 2 CCC). The same rule applies to a person who was sentenced (in a final and non-appealable sentence) for violation of any of the following provisions:

- Acts to detriment of the company (Art. 585 CCC);
- False data announcement (Art. 587 CCC);
- Facilitation of illegal voting (Art. 590 CCC); and
- Participation in illegal voting (Art. 591 CCC).

The period of limitation lasts for five years from the date on which the adjudicating sentence became final and non-appealable. However, it may not cease to apply earlier than upon the third anniversary of the date on which the service of the sentence ended. The regulation does not explicitly state the consequences of a final judgment in the abovementioned cases in relation to directors that are members of the management board at the time when the judgment was made. It is accepted[21] that such a circumstance would constitute an additional ground for expiration of the mandate, in addition to reasons listed in art. 369 § 4-6 CCC (the mandate of the member of the management board expires at the latest on the date of the general assembly which approves the financial report for the last full financial year of service as a member of the management board, also as a result of the death, resignation or dismissal of such member from the management board, or upon submission by the member of the management board of his resignation).

Also a person against whom a ban on conducting of economic activity has to be issued by the court in connection to the insolvency proceeding (art. 373 LBR) cannot represent the company and become a member of management board[22].

[18] Pursuant to this regulation: Where the dominant and the dependent company enter into an agreement which provides for the management of the dependent company or a transfer of profits by such company, excerpts from the agreement with provisions on the liability of the dominant company for damage caused to the dependent company as a result of non-performance or improper performance of the agreement and on the liability of the dominant company for obligations of the dependent company towards its creditors shall be filed in the registration file of the dependent company. If such is the case, the fact that the agreement does not regulate or that it excludes liability of the dominant company referred to in § 1 shall also be disclosed. However, due to a limited number of rules concerning groups of companies and vague language of these provisions, it is in practice possible to draft a clause in the management contract providing for the liability of dominant company according to "general rules". Such language would mean a liability according to the provisions of Art. 415 Civil Code and the burden of proof would be on the claimant (the dependent company). Such liability would take place also if there were no provisions in the agreement.

[19] W. Popiołek [in:] J. Strzępka, *Kodeks spółek handlowych. Komentarz*, Warszawa 2012, 945.

[20] W. Popiołek [in:] J. Strzępka, *Kodeks spółek handlowych. Komentarz*, Warszawa 2012, 945.

[21] G. Suliński [in:] J. Bieniak et. al, *Kodeks spółek handlowych. Komentarz*, Warszawa 2011, p. 124.

[22] A. Kidyba [in:] S. Włodyka, *System Prawa Handlowego*, vol. 2B, Warsaw 2006, p. 349.

Limitations may also result from specific regulations provided in other Acts such as Banking Law[23] or the Act on Economic Activities of Persons in Public Service (art. 2)[24], Act on District Community Self-Government (art.24)[25], Act on Province Self-Government (art. 24.4 and art. 32.5)[26], Act on County Self-Government (art. 21.6 and art. 26.4.)[27] as well as Act on State Enterprise (art. 42.1.)[28]

Further limitations can result from the company's articles, the regulations of the management board and from resolutions of the supervisory board or resolutions of the general assembly (art. 375 CCC). In contrary to the German rules (Satzungsstrenge), Polish company law allows for a broad discretion in shaping of the company's articles. Art. 304 § 3 and 4 CCC is similar in its language to art. 23 § 5 Aktiengesetz. It states that the articles of association may incorporate additional rules if the law permits. The articles of association may incorporate additional provisions unless law provides sufficient regulation or such additional regulation would be conflicting to the nature of the joint-stock company or good practice. Although the similarity between the Polish and German clauses is undisputable, Polish law provides a higher degree of contractual autonomy concerning the internal structure of the company.[29]

2.2 De facto and shadow directors

Provisions of Polish company or civil law do not provide for a regulation that establishes the liability of *de facto* or shadow directors. There is also no case law concerning a legal question of liability attaching to persons other than managers who assume the role of a director in the company.

The concept of *de facto* management surfaces in the discussion about possible liability within a group of companies[30] as there are no positive regulations in the CCC concerning the liability within the group of companies, it follows the general principles of civil law. One could also contemplate art. 296 of the Penal Code which regulates the breach of trust in economic activities, as a regulation providing liability of *de facto* directors. Any person who was entrusted with the management of business of a physical or judicial person on the basis of the statutory provision, decision, or contract, and overstepped its

[23] Act dated 29 August 1997 Dz. U. No. 140, Pos. 939, see Art. 22a (The Management Board of a bank shall be comprised of at least three natural persons) and 22b: (The appointment of two of the members of the Management Board, one of which shall be the President, shall require the approval of the Commission for Banking Supervision. An application for such approval shall be submitted by the Supervisory Board. The Commission for Banking Supervision may request such information and documents concerning the persons mentioned in item 1 as may be necessary to grant the approval. The Commission for Banking Supervision shall refuse its approval for the appointment of a person mentioned in item 1, if that person: 1) has been convicted for a willful criminal offence or a fiscal offence, excluding offences prosecuted under private accusation, 2) has caused documented losses at their place of work or in acting as a member of a governing body of a legal person,
3) has been banned from conducting business activities on own account as well as acting as a representative or agent of an entrepreneur, member of the Supervisory Board or the audit commission in a joint stock company, a limited liability company or a cooperative, 4) fails to meet the requirements laid down in Art. 30 of the Act (documented knowledge of Polish language). The Commission for Banking Supervision shall waive, by a decision issued at the request of the bank's Supervisory Board, the requirement of a documented knowledge of the Polish language, referred to in Art. 30, if this is not necessary for reasons of prudential supervision, in particular considering the level of permissible exposure or the scope of the bank's activities. According to Art. 103 of the Act of [INFINU], at least two members of the brokerage house are required to have higher education and at least three years of experience in capital market's institutions.
5. The Commission for Banking Supervision may refuse to grant its approval for the appointment of a person mentioned above, if: 1) there are criminal proceedings or proceedings involving a fiscal offence conducted against that person, 2) that person has been punished for an offence other than described above.
[24] Dz. U. 2006, No. 216, Pos. 1548.
[25] Dz. U. 2001, No. 142, Pos. 1591.
[26] Dz. U. 2001, No. 142, Pos. 1590.
[27] Dz. U. 2001, No. 142, Pos. 1592.
[28] Dz. U. 2002, No. 112, Pos. 981.
[29] K. Oplustil, A. Radwan, [in:] Ch. Jessel-Holst, R. Kulms (red.), *Private Law in Eastern Europe. Autonomous Developments or Legal Transplants?*, Tübingen 2010, p. 450.
[30] J. Schubel, *Gestaltungsfreiheit und Gestaltungsgrenzen im polnischen Vertragskonzern*, Tübingen 2010, p. 266.

prerogatives by action or non-fulfillment of duties, which caused major damage, can be punished with three months up to five years of imprisonment. In order to provide a full spectrum of regulation that could be taken into account when establishing the liability of *de facto* director, the provisions of art. 9 § 3 of Fiscal Penal Act[31] need to be mentioned. According to this regulation, the perpetrator of fiscal offences is also a person, who based on a decision of a relevant company body, contract or without such, (just factually) conducts businesses, especially financial ones, of a legal person.

Although the CCC does not provide regulations of the position of shadow directors and limitations of their voting right, one could consider measures provided for in art. 411 § 3 CCC as a means to limit the shareholders voting power. The articles of association may cap the voting rights of shareholders holding more than 10% of the total number of votes. The votes which a shareholder holds as a pledgee or usufructuary, or under another legal title are counted towards the total number of the votes controlled by a given shareholder. The limitation may also apply to other persons who control the votes as a pledgee, usufructuary or under another legal title. The limitation may apply only to the exercise of the voting right on shares above the limit of the votes provided for in the statutes. The articles of association may also provide for cumulating of the votes held by the shareholders among whom there exists the relationship of dominance or dependence in the meaning of Code of Commercial Companies or other Acts. However, this limitation of voting rights is independent from the status of controlling shareholder and does not apply to shadow directors specifically.

[31] Dz. U. 2007, No. 111, Pos. 765.

3 The scope of directors' duties under Polish law

3.1 Types of directors' duties

3.1.1 Standard of Care and Diligence

The Polish Code of Commercial Companies provides for the standard of care and due diligence which the corporate officers are obliged to apply to their action. As specified in art. 483 CCC, the members of the management board, the supervisory board and a liquidator, while performing their duties, should act with due care appropriate to their professional position. This provision confirms and recapitulates the language of art. 355 § 2 CC which orders to evaluate the due diligence of the debtor within the scope of his economic activity and professional nature of that activity. The legislator set the bar for a standard behaviour of directors higher than in the case of non-professional individuals. Directors, as well as other corporate officers, are expected to present the knowledge and experience of a business person relevant to the size and profile of the company.[32] The degree of assessment is high, so that in a situation when a person who lacks the relevant knowledge and experience accepts an appointment for the position, his or her act of acceptance might be considered as a breach of standard care.[33] The differentiation is made also among the directors of different companies – it is assumed that a director of an investment fund or bank will have a higher degree of experience or knowledge, than a director of an ordinary company. Polish courts defined the observance of the standard care as "the anticipation of the results of planned actions, the fulfillment of all current and legal measures in order to fulfill managerial duties as well as the preservation of forethought, diligence and prudence that comply with the interest of the company."[34]

3.1.2 Duty of Loyalty and Conflict of Interests

Although Polish company law does not provide for an explicit regulation establishing the duty of loyalty,[35] its existence is broadly accepted.[36] The duty of loyalty may be considered a part of the fiduciary relationship between the company and its director. The existence of such a duty is derived from more detailed regulations provided for in the CCC that do not expressly establish such duty but rather contain a regulation prohibiting certain types of actions (for instance the non-competition

[32] R. Cierpial [in:] S. Kalss, *Vorstandshaftung in 15 europäischen Ländern*, Vienna 2005, p. 662; A. Szajowski [in:] S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. IV, Warszawa 2004, p. 126, Okolski, D. Wajda, *Odpowiedzialność członków zarządu spółek kapitałowych*, PPH 2007 No. 2, p. 11.
[33] K. Oplustil, A. Radwan, [in:] Ch. Jessel-Holst, R. Kulms (red.), *Private Law in Eastern Europe. Autonomous Developments or Legal Transplants?*, Tübingen 2010, p. 481; *T. Dziurzyński* [in:] *Dziurzyński*, *Fenichel*, *Honzatko*, Komentarz, s. 473; Okolski, Wajda, Odpowiedzialność członków zarządu, PPH 2007 No. 2, p. 12.
[34] See Judgment of the Court of Appeal in Katowice of November 5, 1998, I ACa 322/98; in judgment of August 17, 1998, III CRN 77/93, Supreme Court decided that the professional conducting of business activity has to possess relevant knowledge, also in scope of legal regulations concerning the conduct of business activities, See also judgment of the Court of Appeal in Poznań of March 8, 2006, I ACa 1018/05.
[35] The Best Practices Code of 2002 and 2005 expressed a rule (which has been omitted in later versions) that a management board should display fully loyalty towards the company and withhold itself from actions leading to securing only their own individual interest.
[36] Compare: D. Wajda, Obowiązek lojalności w spółkach handlowych, Warszawa 2009, p. 26; R. Czerniawski, *Zarząd spółki akcyjnej*, Warszawa 2008, p. 204;

requirement).[37] Pursuant to art. 380 CCC, a member of the management board may not, without the consent of the company, engage in a competing business, participate in a competing company as a partner in a civil law partnership, a partnership, or as a member of a governing body of a capital company or participate in another competing legal person as a member of its governing body. This restriction also applies to participation in a competing capital company, in which the member of the management board holds at least ten percent of shares or was granted the right to appoint at least one member of its management board.[38] The regulation of art. 380 CCC protects the interest of the company and shareholders from director's performance that constitutes a competitive action.[39] The duty does not apply to persons acting in governing bodies of the competing partnerships.[40] Unless the company's articles provide otherwise, the governing body authorised to appoint the management board gives consent to a director. The consent may be given also after the duty has been breached.[41] It is debated whether a violation of these rules influences the validity of the acts of the director (for instance entering into a contract). According to the Supreme Court, such contract remains valid towards third parties.[42] Provisions of CCC do not provide for a specific remedy, therefore, a director has an obligation to redress the damage caused to the company.[43]

In case of a conflict of interests between the company and directors (or their spouses, relatives, in-laws within the second degree as well as persons with whom the member has a permanent relationship), the affected member of the management board is obliged to withhold from participating in the decision-making process and can make a request that a record of such disclosure be made in minutes (art. 377 CCC).[44] The reason for the introduction of a possibility to withhold oneself from participation in the decision-making process aims at assuring the security of commercial practice and the integrity of the conduct of the company's business.[45] The liability of the director occurs not only if the interest of pecuniary or non-pecuniary nature was direct, but also when it was indirect.[46] It is indicated that the conflict of interest needs to occur to the detriment of a company, irrespective of a possible gain that the director might have achieved.[47] Such a gain may not occur. Article 15 CCC provides for a further regulation which could be regarded as an expression of the duty of loyalty. The conclusion by the capital company of a credit agreement, a loan agreement, a surety agreement or other similar agreement with a member of the management board (but also supervisory board, audit committee, a holder of the commercial power of attorney or a liquidator) for their benefit, requires consent of the general meeting or the general assembly, unless the law provides otherwise. The conclusion of an abovementioned agreement between the dependent company with a member of the management board (or abovementioned persons) of the dominant company requires the consent of the general meeting of the dominant company.

[37] D. Wajda, *Obowiązek lojalności w spółkach handlowych*, Warszawa 2009, p. 237.
[38] See also D. Wajda, *Obowiązek lojalności w spółkach handlowych*, Warszawa 2009, p. 230.
[39] A. Kidyba [in:] S. Włodyka, *System Prawa Handlowego*, vol. 2A, Warsaw 2006, p. 346
[40] W. Popiołek in: J. Strzępka, *Kodeks spółek handlowych. Komentarz*, Warszawa 2012, p. 973; M. Rodzynkiewicz, *Kodeks spółek handlowych. Komentarz*, Warszawa 2012, p. 392. Criticized by: S. Sołtysiński [in:] S. Sołtysiński, *System Prawa Prywatnego. Prawo spółek kapitałowych*, vol. 17B, p. 484
[41] W. Popiołek in: J. Strzępka, *Kodeks spółek handlowych. Komentarz*, Warszawa 2012, p. 974; A. Kidyba [in:] S. Włodyka, *System Prawa Handlowego*, vol. 2B, Warsaw 2006, p. 349.
[42] The judgement of the Supreme Court, datek January 11, 2002, IV CKN 1903/00; criticized by S. Sołtysiński [in:] S. Sołtysiński, *System Prawa Prywatnego. Prawo spółek kapitałowych*, vol. 17B, p. 484.
[43] A. Kidyba [in:] S. Włodyka, *System Prawa Handlowego*, vol. 2B, Warsaw 2006, p. 349.
[44] See also D. Wajda, *Obowiązek lojalności w spółkach handlowych*, Warszawa 2009, p. 217; J. Szwaja, S. Stanisławska-Kolc, *Obowiązek wtrzymania się członka zarządu od rozstrzygania spraw (art. 202 i 373 KH)*, PS 2000, No. 3, p. 9; R. Czerniawski, *Zarząd spółki akcyjnej*, Warszawa 2008, p. 206.
[45] The judgment of Supreme Court dated January 11, 2002, IV CKN 1903/00.
[46] A. Kidyba [in:] S. Włodyka, *System Prawa Handlowego*, vol. 2A, Warsaw 2006, p. 327–328.
[47] A. Kidyba [in:] S. Włodyka, *System Prawa Handlowego*, vol. 2A, Warsaw 2006, p. 328.

Any action which is undertaken in a situation when a conflict of interest takes place is considered valid. Nevertheless, a breach of duty of loyalty may result in the liability of the director[48] (based on art. 483 CCC or 415 CC). In case of persons who do not hold the function (procurent/holder of commercial power of attorney, power of attorney) that would invoke liability under CCC can be held liable on the basis of art. 415 CC.

3.1.3 Business Judgment Rule

In contrast to German law (art. 93 AktG), the Polish Code for Commercial Companies does not contain any provisions stating that in making a business decision, the directors of a company act on an informed basis and in good faith. Therefore, it cannot be presumed that the director met the standard of due care and diligence. In fact, the opposite is true. In case a suit against a director based on art. 483 CCC was filed, the burden of proof in the legal proceedings rests upon the director. Also the Supreme Court seems to support such interpretation, as it stated that a reference to an economic risk cannot exculpate the manager when damage caused to the company was the result of careless management.[49] However, in some judgments Polish courts accepted a degree of managerial discretion when accepting risks inherent to the economic activities, if the director follows the proper standard of care and loyalty towards the company.[50]

3.2 To whom are the duties owed?

The management board has a general duty to manage the company's affairs and represent it when dealing with third parties. Where the management board is composed of more than one person, all of its members have the right and duty to jointly conduct the company's affairs unless the articles provide otherwise (art. 371 § 1). The duties may result from both public and private law provisions. Polish law does not provide for rules that would allow differentiating between their importance.

The duties are generally owed to the company. There is no legal definition of the company's interest, however this term appears in several regulations of the CCC. For instance, the provision of art. 377 CCC requires directors who are in a conflict of interest not to vote on a board's resolution which can be seen as a rule aimed to protect the company's interest. The notion functions as a general clause and it is not quite settled how to interpret an abstract idea of an interest of a legal person. In the literature it is emphasised that this term (undefined in the statutory provisions) should not be interpreted in an abstract manner, disconnected from the interest of its investors.[51] The company's interest is recognised to have an accessory character to the interest of shareholders.[52] The company does not exist "for itself", rather in order to carry out the economical interest of groups involved in it (shareholders, stakeholders, directors). This, however, does not mean that all these interests have the same weight when it comes to considering the company's interest. As the shareholders are the beneficiaries of the company and residual claimants, it is their interest that should have the strongest influence on the interpretation of a general clause of "company's interest".

[48] W. Popiołek in: J. Strzępka, *Kodeks spółek handlowych. Komentarz*, Warszawa 2012, p. 964.
[49] Judgment of Supreme Court of May 9, 2000, IV CKN 117/00.
[50] Judgment of Supreme Court of 26 January 2000, I PKN 482/99; judgment of the Court of Appeal in Wroclaw, II AKa 326/10.
[51] A. Opalski, *O pojęciu interesu spółki*, PPH 2008 No. 11, p. 17; K. Oplustil, *Instrumenty nadzoru korporacyjnego (corporate governance) w spółce akcyjnej*, Warszawa 2009, p. 173; see also the judgment of November 5, 2009, I CSK 158/09, OSNC 2010, No. 4, pos. 63.
[52] A. Opalski, O pojęciu, p. 17; K. Oplustil, *Instrumenty nadzoru korporacyjnego (corporate governance) w spółce akcyjnej*, Warszawa 2009, p. 174.

3.3 The director as a shareholder

Shareholders of a joint-stock company may become company's directors. Provisions of CCC do not provide for alternations in director's duties who simultaneously have a shareholder status. Such status affects the voting rights of a shareholder who according to art. 413 CCC may not, in person or by proxy, or as a proxy of another person, vote on resolutions on his liability towards the company on any account, including the granting of approval of performance of his duties, release from an obligation towards the company or a dispute between him and the company. The shareholder in a public company may vote as a proxy on resolutions concerning his person, referred to in § 1. The provisions of Article 412^2 § 3 and 4 shall apply *mutatis mutandis.* If a member of the management board, a member of the supervisory board, a liquidator, an employee of a public company or a member of the bodies or an employee of its dependent company or cooperative serves as a proxy at the general assembly, the proxy may authorise him to represent the shareholder at one general assembly only. The proxy shall disclose to the shareholder all circumstances giving rise to an existing or a possible conflict of interest. A further proxy may not be granted. The proxy referred to in art. 412^2 § 3 shall vote in accordance with the instructions given by the shareholder.

3.4 The time span of the duties

The duties as well as the liability begin with the moment of an appointment and end either with the lapse of the term of office or dismissal of the director. The appointment of a director requires the director's consent and is valid from the moment when the director's declaration of intention reaches the offeree (art. 61 CC). A member of the management board may not serve for more than five years (term of office). Reappointments of the same person as a member of the management board shall be allowed for terms of office not longer than five years each. The appointment may be made not earlier than one year before the end of the current term of office of the member of the management board (art. 369 § 1 CCC). The statutes may, within the time limits referred to in § 1, provide for a partial renewal of the management board in such a way that a certain number of the members of the management board step down in an order determined by a draw of lots, or by seniority of appointment or in another order. If the statutes stipulate that members of the management board shall be appointed for a common term of office, the mandate of the member of the management board, appointed before the end of a given term of office of the management board, shall expire simultaneously with the expiry of the mandates of the remaining members of the management board, unless the statutes of the company provide otherwise, 369 § 3 CCC.

The mandate of the director expires also at the latest on the date of the general assembly which approves the financial report for the last full financial year of service as a member of the management board, as well as a result of the death, resignation or dismissal of such member from the management board (art. 369 § 4 and 5 CCC).

Nevertheless, some duties do not cease to bind the former manager. A dismissed member of the management board shall be entitled and obligated to offer explanations in the course of drafting the management board report and the financial report for the period of his service as a member of the management board, and to participate in the general assembly held to approve the reports referred to in Article 395 § 2 point 1, unless the instrument of dismissal provides otherwise (Art. 370 § 3 CCC). Dismissed members of the management board cannot use confidential information concerning the company.[53] If a former member of the management board uses such information, the liability under the Act on Combating Unfair Competition Practices, art. 11.1, can take place.[54]

3.5 Application of duties to de facto and shadow directors

Provisions of Polish company or civil law do not provide for a regulation that establishes the liability of de facto or shadow directors. There is also no case law concerning a legal question of liability attaching to persons other than managers who assume the role of a director in the company. Also no statutory provisions allow for application of duties to de facto and shadow directors. Should damage to the company be caused by anyone, their liability can be, established on the basis of the provisions of the Civil Code concerning tort liability (art. 415 CC).[55]

[53] A. Szajkowski, M. Tarska, A. Szumański [in:] S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. III, Warszawa 2004, p. 644.
[54] A. Szajkowski, M. Tarska, A. Szumański [in:] S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. III, Warszawa 2004, p. 644.
[55] Art. 415 CC: Whoever by his fault caused damage to another person shall be obliged to redress it.

4 LIABILITY FOR BREACH OF DUTY

The Civil liability of company directors should play a preventive as well as compensatory function.[56] The latter function should not be overestimated in a joint-stock company because the damage can hardly ever be compensated from the limited financial means of directors. It is possible to hold the directors liable simultaneously on the basis of general civil liability rules as well as the rules provided in the CCC.[57] According to Art. 490 CCC, provisions of Articles 479-489 shall be without prejudice to the rights of shareholders and other persons to seek redress of damage in accordance with general rules. Similarly, in case of penal provisions, members of the management board can be held liable on the basis of penal provision in the CCC as well as these in the Penal Code.[58]

4.1 Liability towards the company

Filing a law suit against a director requires prior approval of the shareholders' meeting (art. 393 CCC). Pursuant to art. 483 CCC, in order for the director's liability to occur, the following premises have to be fulfilled:

1) The action or inaction was caused by the director;
2) The damage occurred (actual damage *damnum emergens* and lost profits *lucrum cessans*);
3) There is a causal link between the damage inflicted upon the company and the director's behavior; and
4) The director's contributing behavior (action or inaction) was illegal or violated the company's articles.

In the opinion of the majority of scholars,[59] only formally appointed directors can be held liable and not the holder of commercial power of attorney (procuration/commercial proxy)[60] or power of attorney.[61] The liability of these persons can be, however, established on the basis of the provisions of the Civil Code concerning tort liability (art. 415 CC).[62]

As far as the damage is concerned, pursuant to art. 361 § 2 CC, it covers all the losses incurred by the injured person (it the company) as well as the benefits which that person could have obtained had he not suffered the damage.[63] The scope of damage is limited by art. 365 § 1 CC (Adequacy Theory) according to which the person obliged to pay for damages is liable only to the normal effects of the act or omission from which the damage resulted.

[56] K. Oplustil, *Instrumenty nadzoru korporacyjnego (corporate governance) w spółce akcyjnej*, Warszawa 2009, p. 755.
[57] R. Szczęsny, *Odpowiedzialność zarządu w spółkach kapitałowych*, Kraków 2004, p. 422–423.
[58] R. Szczęsny, *Odpowiedzialność zarządu w spółkach kapitałowych*, Kraków 2004, p. 439.
[59] See A. Szajkowski [in:] S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. IV, Warszawa 2004, p. 127.
[60] Pursuant to Art. 109^1 CC, procuration is power of attorney granted by an entrepreneur obligated to be entered in the register of entrepreneurs. It includes the authorization to perform court acts and out-of-court acts connected with the running of an enterprise.
[61] General Power of attorney confers authorization to acts of ordinary management. Acts which exceed the scope of ordinary management require a power of attorney specifying their kind, unless statutory law provides a power of attorney to a particular act.
[62] Art. 415 CC: Whoever by his fault caused damage to another person shall be obliged to redress it.
[63] See A. Szajkowski [in:] S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. IV, Warszawa 2004, p. 134; R. Cierpial [in:] S. Kalss, *Vorstandshaftung in 15 europäischen Ländern*, Vienna 2005, p. 671.

The scope of liability under art. 483 CCC is broad and covers all actions or inactions of directors that violate the statutory law or the company's articles.[64] Under this term also a negligent conduct of the company's business is understood.[65] The provision is wide enough that a director can be held liable for their breach of duties to execute the company's business with duty and care as well as duty of loyalty (that are indirectly interpreted from CCC provisions).

It is controversial, whether liability may be assigned to directors for damage occurring in a group of companies.[66]

4.1.1 Liability for damages caused in period of incorporation

A person who, while participating in the incorporation of a company, in a breach of the law through his fault caused damage to the company, shall be liable to redress it. In particular, liability rests with a person who: included, or collaborated in including, in the statutes, reports, opinions, announcements and records, false data or disseminated such data in another manner, or omitted or collaborated in omitting in such documents data material for the creation of the company, in particular that pertaining to in-kind contributions, acquisition of property, or granting to the shareholders or other persons of remuneration or other special benefits, or collaborated in activities aimed at ensuring registration of a company on the basis of a document containing false data. The scope of this provision is debated by the scholars. It is undisputable, however, that it extends to the company's directors in case they were involved in creating the company. If a company that suffered damage would not be inscribed into the entrepreneur's register, it will not become a legal subject that can file a law suit.

Also a person who, in connection with the creation of a joint-stock company or an increase of its share capital, through his fault, secures for himself or a third party a payment excessively higher than the sale value of in-kind contributions or the acquired property, or a remuneration or special benefits disproportionate to the services rendered, shall redress damage caused to the company (art. 481 CCC).

Pursuant to Aat. 13 CCC, the company and the persons who acted in its name shall be liable for the obligations of the capital company in organisation.

4.2 Liability towards third parties

4.2.1 Tort liability

Pursuant to art. 490 CCC, the provisions of the Code do not prevent the shareholders or third parties from seeking redress of damage in accordance with general, civil law, regulations. Polish civil law provides for tort liability in case of every wrongful action that causes damage to the injured person: "whoever by his fault caused a damage to another person shall be obliged to redress it" (art. 415 CC). Therefore, directors can be liable on this basis towards the third parties. The liability occurs if there is a damage, action and a causal link between them. Damage is defined as an injury to interest

[64] A. Szajkowski, S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. IV, Warszawa 2004, p. 131.
[65] W. Popiołek in: J. Strzępka, *Kodeks spółek handlowych. Komentarz*, Warszawa 2012, p. 1183.
[66] W. Popiołek [in:] J. Strzępka, *Kodeks spółek handlowych. Komentarz*, Warszawa 2012, p. 1185.

protected by law. Illegality of action constitutes an element of fault. Only unlawful acts or omissions may be deemed to have been caused by someone's fault. An illegal action is every action that violates the legal order, also the principles of community life. It is sufficient for a contractor to act disloyally in order for the liability to breach of such principles. The causal link is limited to normal effects of the act or omission from which the damage resulted.

4.2.2 Liability for providing false data

Pursuant to art. 479 CCC, if members of the management board, willfully or out of negligence, have provided false data in the representation referred to in Article 320 § 1 points 3 and 4 or in Article 441 § 2 point 5, they shall be liable to the creditors of the company, jointly and severally with the company, for three years from the date of registration of the company or registration of the increase of the share capital. Pursuant art. 320 § 1 no. 3 CCC an application for filing of a joint-stock company with the registry has to include an attachment providing a representation of all members of the management board that the payments towards the shares and the in-kind contributions required under the statutes have been made as provided for in the law. No. 4 specifies that this filing has to be accompanied by a proof, certified by a bank or an investment company, that payment for the shares has been made into the company's account. Where the statutes provide for financing contributions in-kind, the application has to include a certification of all members of the management board that the receipt of such contribution by the company is ensured. Pursuant to art. 441 § 2, the management board is obliged to attach to the report on the increase of the share capital to the registry court a representation of all members of the management board that the contributions towards the shares have been made; where the in-kind contributions are to be made after registration of the increase of the capital, a representation that the transfer of such contributions to the company within the time stipulated in the resolution on the increase of the share capital is ensured.

4.2.3 Dissemination of false data

A person who has collaborated in the issuing by the company, directly or through third parties, of shares, bonds or other titles giving the right to participate in the profits or division of assets shall redress damage caused if he included in the announcements or records false data or disseminated such data in another manner or, when providing data on the assets of the company, concealed circumstances which should have been disclosed in accordance with the law in force (art. 484 CCC). The liability may concern, but is not strictly restricted to, directors of the company. The damage will be primarily caused to the buyer of the financial instruments and the liability towards the company will have secondary character.

4.2.4 Liability for providing false data under capital market law

In this context one should mention liability for false data that results from the Act on Public Offering, Conditions Governing the Introduction of Financial Instruments to Organized Trading and Public Companies.[67] The company, but also the members of management board bear liability for preparing information, as the realisation of the company's obligations falls within the scope of conducting its business under art. 368 § 1 CCC. As the articles of association may shape the scope of these duties and provide for specification of tasks (art. 371 § 1 CCC), they cannot exclude the liability of all the

[67] Compare T. Sójka, Obowiązki informacyjne spółek publicznych i odpowiedzialność cywilna za ich naruszenie, Warszawa 2008, p. 218; R. Czerniawski, *Zarząd spółki akcyjnej*, Warszawa 2008, p. 212.

officers.[68] Pursuant to art. 98 of the Public Offering Act, a person responsible for providing true, reliable and complete information in the public-offer prospectus, information memoranda or other documents prepared and published in connection with the public offering of securities or financial instruments, is required to redress the damage caused by the breach of these duties. The civil law liability provided by this regulation is based on the tort liability. It is joint and several. The presumption of fault is rebuttable, but in practice it can be difficult to provide evidence that the fault did not occur, as the persons whose duty it is to provide data should act with the duty of care resulting from the professional character of the activity. The legislator did not limit the scope of persons who can claim the damage and attempt to enforce director's liability (it is any person who suffered damage).[69]

Pursuant to art. 100 of the Public Offering Act, a person liable for the information in the public-offering prospectus can be punished with a fine up to PLN 5.000.000 or the imprisonment from six months to five years, or both these penalties.

The Act on Trading in Financial Instruments prohibits the use of confidential information acquired by the members of the management board in connection to the fulfillment of their function (art. 156.1). Directors are prohibited from acquiring, selling for themselves or a third party the stock of the company or other financial instruments (art. 159.1). In the case of the breach of this duty, Polish Financial Supervision Authority may, pursuant to art. 174 of the Act on Trading in Financial Instrument, issue an administrative decision imposing a fine of maximum PLN 200.000.

4.2.5 Liability incurred in the process of merger or division and transformation of the company

As far as directors' liability in the situation of a transformation of a company, its merger or division is concerned, the Polish legislator provided for a set of identical rules in art. 512 § 1 CCC. The Polish legislator provided regulation of joint and several liability of the members of the management board, the supervisory board or the audit committee and the liquidators of the merging companies or dividing company to the shareholders of such companies for damage caused by acts or omissions in breach of the law or the provisions of the articles of association or the statutes, unless they are not at fault. In all abovementioned situations, Articles 483 § 2 CCC, 484 CCC and 486 § 2–4 CCC apply. Claims for redress of damage shall be barred by limitation after three years from the date of the announcement of the merger.

Pursuant to art. 495 § 2 CCC, members of the governing bodies of the acquiring company or the newly formed company shall be jointly and severally liable for the separate management of assets of each of the merged companies until the date on which the creditors whose claims antedate the merger date, and who, prior to the end of six months of the date of the announcement of merger, demanded the payment in writing, are satisfied or secured. There are two positions in the legal doctrine concerning the character of such liability. It is argued that it is independent from the damage caused by the directors to the creditor, because the premise is plainly mismanagement of assets.[70] Some scholars present a view that the liability is compensatory and will not take place if there is no fault in mismanagement of assets.[71]

[68] T. Sójka, Obowiązki informacyjne spółek publicznych i odpowiedzialność cywilna za ich naruszenie, Warszawa 2008, p. 219.
[69] T. Sójka, Obowiązki informacyjne spółek publicznych i odpowiedzialność cywilna za ich naruszenie, Warszawa 2008, p. 242.
[70] A. Szumanski [in:] S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. IV, Warszawa 2004, p. 277.
[71] M. Rodzynkiewicz, *Kodeks spółek handlowych. Komentarz*, Warszawa 2009, p. 909; D. Walerjan, T. Żak, *Odpowiedzialność członków zarządu spółek kapitałowych oraz praktyczne sposoby jej ograniczenia*, Warszawa 2010, p. 108–109.

In case of a transformation of a company, pursuant to art. 468 § 1 CCC, persons acting for a company being transformed are jointly and severally liable to the company, shareholders and third parties for damage caused by acts or omissions in breach of the law or the articles or statutes of the company, unless they are not at fault. Any possible claims shall be barred by limitation after three years from the transformation date.

4.2.6 Liability for company's tax obligations

Pursuant to art. 116 of the Tax Ordinance Act of August 29, 1997,[72] the members of the management board bear joint and several liability with all their assets for the tax arrears of a joint stock company or a joint stock company,[73] if the execution against the company's assets proves to be fully or partially ineffective. The manager may escape such liability by demonstrating that (i) a petition for bankruptcy was filed, or proceedings preventing the declaration of bankruptcy (composition proceedings) were commenced at the appropriate time, or (ii) he or she is not responsible for a petition for bankruptcy not being filed, or the proceedings preventing the bankruptcy (composition proceedings) not being commenced. The liability of members of the management board shall include tax arrears by virtue of the obligations for which the payment deadline elapsed within the period in which they performed their duties as members of the management board, and the arrears that arose within the period in which they performed their duties as members of the management board.[74] Liability for tax obligations relies on the formal premise of "holding the management position" and arises independently from the fact that a director in fact did not attend to the company's interest in that period of time, or if the director had such possibility.[75]

The same liability concerns the obligations resulting from the Social Insurance System Act of October 13, 1998.[76] According to art. 31 thereof, the provisions of art. 116 of the Tax Ordinance Act are applied accordingly also to social insurance obligations.

4.2.7 Liability under Labor Code and Act on Social Insurance Act

Pursuant to art. 281 Labor Code,[77] directors may be liable for the obligations of the employer specified in this Act. A fine in the amount 1.000,00 – 30.000,00 PLN may be imposed when the employer or a person appointed by him concludes a civil-law contract where an employment contract should be concluded, does not confirm in writing an employment contract concluded with an employee, terminates an employment contract with an employee with or without notice, seriously violates the provisions of labour law, applies penalties towards the employees other than those provided for in the provisions of labour law on the liability of employees for maintaining order, violates the provisions on working time or the provisions on the rights of employees connected with parenthood or the employment of young people, does not keep documentation in employment matters and personal files of employees or leaves documentation in matters related to an employment relationship as well as personal files of employees in conditions threatened by damage or destruction.

[72] Dz. U. No. 137, Pos. 926, as amended.
[73] Also a limited liability company, a limited liability company in organisation,
[74] If a joint stock company in organization has no management board, its attorney shall be liable for the company's tax arrears, or its shareholders if no attorney was appointed. The provisions concerning the tax liability of directors apply accordingly.
[75] See judgment of WSA in Krakow of July 15, 2008, I SA/Kr 1249/07.
[76] Dz. U. No. 137, Pos. 887, as amended.
[77] Dz. U. 1998, No 98, Pos. 94.

Pursuant to art. 98 of the Social Insurance System Act, members of the management board can be liable up to 5.000,00 PLN if a breach of one of the following duties occurs: failure to pay of the social insurance contributions within the deadline provided by the statutory law, non-fulfillment of information duties or furnishing of false information, insufficient performance of control in the company, mismanaging documentation of the social insurance contribution.

4.3 Exemptions and limitations

The company's claim may expire if the company and director enter into a contract which pursuant to art. 508 CC releases the debtor from the debt.[78] A settlement agreement is also possible. Pursuant to art. 395 CCC, the shareholder's meeting has to give its consent to such an agreement. The company has to be represented by the supervisory board or a proxy, otherwise the contract will be null and void (art. 58 CC).

The shareholders' meeting can issue a resolution releasing the directors from liability.[79] It is debated in the literature whether a resolution releasing the directors from liability would have effect. However, there is a common consent that the lack of such resolution does not automatically mean that the director bears liability.[80] The resolution can limit the scope of liability only to the facts known to the shareholders' meeting at the time the resolution was made.[81]

However, these two forms of limiting liability do not fulfill their protective function in case of a derivative action (art. 487 CCC, see below) or in case of insolvency (see below). On the one hand, due to a broad scope of these clauses it may be rather difficult to successfully limit director's liability. On the other hand, however, derivative actions do not often take place.

The last means to limit liability is by dividing tasks of each director in the company's articles of association. These provisions can influence the scope of the director's liability. If there is a clear assignment of tasks and one director supervises financial operations and the damage occurred on this field, the liability of this manager increases.[82] One cannot entirely exclude the liability based on the division of tasks between the managers.

Because managers also can have an employment contract, it has to be noted that any limitation resulting from the labour law[83] that allows a cap for a liability of an employer of a maximum amount of three monthly salaries (art. 119 Labor Code) is not applicable in the case of directors.[84]

When defending their case, members of the management board in a joint-stock company cannot argue that they merely acted according to the resolution of the shareholders' meeting because the general assembly and the supervisory board may not give the management board any binding

[78] R. Cierpial [in:] S. Kalss, *Vorstandshaftung in 15 europäischen Ländern*, Vienna 2005, p. 664.
[79] R. Cierpial [in:] S. Kalss, *Vorstandshaftung in 15 europäischen Ländern*, Vienna 2005, p. 665
[80] W. Popiołek [in:] J. Strzępka, ***Kodeks spółek handlowych.*** *Komentarz*, Warszawa 2012, p. 1185.
[81] A. Szajkowski [in:] S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. IV, Warszawa 2004, p. 138.
[82] W. Popiołek [in:] J. Strzępka, ***Kodeks spółek handlowych.*** *Komentarz*, Warszawa 2012, p. 1185.
[83] Labour Code of 23 December 1994, Dz. U. 1998, No. 21, Pos. 94. Art 119 LC: Compensation is assessed on the amount of the damage caused, but cannot exceed three months' remuneration due to the employee on the date the damage was caused. Also according to Art. 120 LC, when damage is caused by an employee to a third person through performing his work duties, only the employer is obliged to compensate for the damage.
[84] T. Sójka, Obowiązki informacyjne spółek publicznych i odpowiedzialność cywilna za ich naruszenie, Warszawa 2008, p. 223.

instructions with respect to the management of the affairs of the company (art. 375[1] CCC).[85] Should such a resolution be made, it can be taken into account only as an advice to the management board.[86] Therefore, its content can be considered when deciding on lowering the company's claim against the director, as the court may see such resolution as a contribution to damage on the side of the company.[87] Polish companies tend towards concentrated ownership, therefore a guidance of the shareholders' meeting dominated by one investor[88] cannot be easily ignored by the management board.

4.4 Insurance against liability

Polish law allows for directors' civil liability insurance and its popularity has been steadily growing since its introduction in Poland 15 years ago because of the increase of risk-awareness connected with the leading position in a company. From an unknown product in the mid-90's, this type of insurance became almost a necessity in times of an unstable economy, the financial crisis, currency options problems and a slowdown of the construction market. Due to these factors the liability for damages caused by decisions of professionals became more apparent. Although the market for D&O insurance is still developing, the insurance premium for the year 2010 oscillated between 30–50 million PLN.[89] It is also a company that benefits from providing a D&O liability insurance, because it lowers the risk aversion of the management. Secured management is willing to make more difficult decisions and, therefore, create a bigger profit for the shareholders. The company is also more likely to regain its losses in case the risky decisions turn out wrong.

As a general rule, it is the company that insures the managers, but a personal insurance contract of a manager can also take place. There are two basic types of D&O insurance contracts. First, the contract may cover individually named managers. In the second type, the provisions would be drafted in regards to the unspecified amount of persons who occupy a management position in the company.[90] The contracts specify the period for which the insurance is available. It also defines triggers – such as an occurrence of action or inaction that caused a damage to the company, the point in time when the damage becomes apparent, or rise of a claim.[91]

When the director is insured, depending on the provisions of the contract, the company can sue the manager insurer directly or have a claim against the insurer after a final judgment has been made against the former employee. In such a case the insurer can also act in the proceedings against the manager as an intervener. Polish law of civil procedure allows a party to notify and call to attend the proceedings against a third party against whom it would have a claim in case of a negative court judgment (art. 84 Code of Civil Procedure). A sued manager will notify the insurance company that it can step into the proceedings and argue in his favour in order to lessen its own liability because the insurer will be obliged to pay to the company in case a court issues a judgment against the manager.

[85] See A. Szajkowski S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. IV, Warszawa 2004, p. 126.
[86] R. Cierpial [in:] S. Kalss, *Vorstandshaftung in 15 europäischen Ländern*, Vienna 2005, p. 664.
[87] R. Czerniawski, Zarząd spółki akcyjnej, Warszawa 2008, p. 114.
[88] K. Oplustil, A. Radwan, [in:] Ch. Jessel-Holst, R. Kulms (red.), *Private Law in Eastern Europe. Autonomous Developments or Legal Transplants?*, Tübingen 2010, p. 474.
[89] See the Article provided on the page of Polish Insurance Ombudsman accessed on 10.4. 2012 http://rzu.gov.pl/aktualnosci-z-rynku/ubezpieczenia-majatkowe/Coraz_wieksze_zainteresowanie_polisami_OC_dla_menedzerow__D_O___1901; compare also information provided by article dated 16.4.2011, accessed on 10.4.2012 http://www.parkiet.com/artykul/10,1041885.html.
[90] D. Walerjan, T. Żak, *Odpowiedzialność członków zarządu spółek kapitałowych oraz praktyczne sposoby jej ograniczenia*, Warszawa 2010, p. 203.
[91] D. Wajda, *Ubezpieczenia directors and officers D&O*, Pr. Sp. 2007, No. 3, s. 52; J. Okolski, D. Wajda, *Odpowiedzialność członków zarządu w spółkach kapitałowych*, PPH 2007 No. 2, p. 12–13.

As far as the tax issues are concerned, Poland follows the principle that every income is taxable (with the exceptions provided by the statutory regulation).[92] The insurance rates may, therefore, constitute an income, according to art. 11.1 of Natural Persons Income Tax Act. The logic behind interpretations given by the Revenue Offices in Poland is that managers do not have to spend their own compensation on the insurance which is covered by the company, therefore they derive a financial gain from the contract.[93] It has to be noted, however, that the courts tend to differentiate this matter. According to the decision made by the District Administrative Courts in Warsaw, the insurance premium can be classified as an income, only if it is allocated to an individual beneficiary.[94]

[92] Art. 9.1. of Natural Persons Income Tax Act Dz. U. 1991, No. 80 Pos. 350 as amended.
[93] Director of the Revenue Office in Warsaw, interpretation dated 16 July 2009 (IPPB2/415-336/09-4/AS); also interpretation dated 26 January 2009 (IPPB2/415-1650/08-4/AS), interpretation dated 3 September 2008 (IPPB2/415-900/08-2/MK), Director of the Revenue Office in Poznań, interpretation dated 5 June 2009 (ILPB1/415-335/09-4/AK) also interpretation dated 26 March 2009 (ILPB1/415-41/09-2/AMN).
[94] WSA 10 December 2007, III SA/Wa 1302/07; WSA dated 26 February 2009, III SA/Wa 2019/08.

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 The meaning of 'vicinity of insolvency'

Polish Insolvency Law provides for reorganisation proceedings. According to art. 21.4 polish Bankruptcy Law, the petitioner can file for reorganisation when the delay in carrying out the company's obligations does not have a permanent character and the sum of the obligations that were not carried out does not exceed 10% of the balance value. Pursuant to art. 492 BRL, an entrepreneur is considered to be threatened with insolvency even if it duly performs its obligations, when - based on a rational estimate of its economic condition - it is evident that the entrepreneur will become insolvent shortly. The reorganisation is not available to an entrepreneur who has already conducted reorganisation proceedings, if two years have not yet elapsed since the discontinuation of the proceedings, has already been covered by an arrangement made in the reorganisation or bankruptcy proceedings, if five years have not yet elapsed since the performance of the arrangement, against which bankruptcy proceedings were conducted which included the liquidation of the bankrupt's assets or in the course of which liquidation arrangement was adopted, if five years have not yet elapsed since a valid closure of these proceedings or in relation to which the petition to declare bankruptcy was dismissed or the bankruptcy proceedings were discontinued due to a lack of assets sufficient to satisfy the costs of the proceedings, if five years have not yet elapsed since the date these proceedings became valid. The reorganisation plan should allow for the recovery by the entrepreneur of the ability to compete on the market. The plan shall contain a justification.

The effects of opening, art. 489 BRL, the reorganisation proceedings are following: the payment of the obligations is suspended as well as accrual interest due from the company. A setoff of claims is admissible and no execution proceedings against the company may be opened while the opened ones are stayed by virtue of law.

An expert is appointed for the company and the entrepreneur has to conclude without delay a mandate agreement with the court supervisor on performing a supervisor's duties and pay it gradually the remuneration amounting to double the average monthly salary in the enterprise sector, excluding payments from profit, in force in the fourth quarter of the preceding year, published by the President of the Main Statistical Office.

The opening of reorganisation proceedings shall not affect the opening of court proceedings against the entrepreneur, including proceedings to declare bankruptcy upon a petition of the creditor, as well as administrative proceedings (Art. 499 BRL).

From the date reorganisation proceedings are opened until a valid adjudication on the approval of the arrangement or until the discontinuance of the proceedings, the entrepreneur may not alienate or encumber its assets.

5.2 Newly arising duties

The petition for reorganisation does not change the duties of the directors nor does it cause the new ones to arise. It should be noted that according to penal provisions of BRL, art. 522, whoever being a debtor or a person authorised to represent the debtor, which is a legal person or a commercial partnership, includes untrue data in the petition to declare bankruptcy or in the statement on opening reorganisation proceedings, is subject to a penalty of imprisonment from three months up to five years. The same penalty can be imposed on whoever being a debtor or a person authorised to represent the debtor, which is a legal person or a commercial partnership, in the proceedings to declare bankruptcy or in the reorganisation proceedings, provides the court with untrue information on the condition of the debtor's assets. Also, pursuant to art. 523 BRL, a penalty of three months up to five years may be imposed on whoever being a person authorised to represent the company does not release to the trustee all of the assets, book accounts, and other documents or does not provide them.

Directors who fail to file for bankruptcy may face liability based on provisions of 586 CCC and of the Law on Bankruptcy and Reorganizations (LBR) dated February 28, 2003.[95] The liability is individual, and irrespective of the activities carried out within the scope of the director's tasks within the managing body. According to art. 21.1 LBR, the debtor is obliged to file the petition within two weeks from the moment when the reason to file for bankruptcy occurred. In case of a legal person, this burden rests upon the individuals with power to represent it, either individually or jointly with other persons.[96] Should a petition be filed after the statutory deadline, the directors would be personally liable for such failure. The liability under LBR is considered a sanction for conducting the company's businesses in a manner that leads to the ineffectiveness of execution against the entity.[97]

Should the director fail to file the petition, the court may ban the conduct of economic activity on one's own account for a period of three to ten years, or by serving on a member of the supervisory board, representative or attorney-in-fact of a commercial company or partnership, state enterprise, co-operative, foundation or association (art. 373.1 LBR). Such failure can also trigger directors' tax liability, who may have to pay the company's tax liabilities for the period before and after filing the petition.[98] Only timely filing of a petition for bankruptcy can protect the director from liability.[99] It needs to be noted, however, that there are controversies as to the practical interpretation of the term "two weeks from the moment when the premises for bankruptcy occurred."[100] The moment when the reason to file for bankruptcy occurred is defined as the company failure to perform its obligations or as a situation when the sum of its obligations exceeds the value of its assets, even if the debtor duly performs these obligations (art. 11 LBR).

An application for a ban on conducting of economic activity may be filed within a year since the end of the bankruptcy proceedings.[101] The ban may be applied if the director following the declaration of bankruptcy, failed to release or identify the assets, records, correspondence or other documents of the bankrupt, despite being obliged to do so under LBR, concealed, destroyed or encumbered the assets included in the bankruptcy estate, or in the course of the bankruptcy proceedings, did not fulfill other obligations imposed upon him under LBR or by the judgment of the court or the judge-commissioner,

[95] Dz. U. No. 60, Pos. 535.
[96] Okolski, Wajda, Odpowiedzialność członków zarządu, PPH 2007 No. 2, p. 12; K. Oplustil, A. Radwan, [in:] Ch. Jessel-Holst, R. Kulms (red.), *Private Law in Eastern Europe. Autonomous Developments or Legal Transplants?*, Tübingen 2010, p. 483.
[97] Judgment of the Supreme Court, dated 8 December 2010, V CSK 172/10.
[98] See NSA October 17, 2006, I FSK 85/06; WSA Olsztyn, August 27, 2009, I SA/Ol 443/09.
[99] Judgment of the Supreme Court, dated April 12, 2006, III CSK 47/06.
[100] Compare judgment of WSA in Warsaw, dated February 16, 2011, III SA/WA 1410/10.
[101] See also decision of the Supreme Court dated March 5, 2009, III CSK 279/08.

or has in any other manner impeded the proceedings. When issuing the ban the court takes into consideration the degree of the director's fault and the effects of undertaken activities, in particular the decrease in the economic value of the bankrupt's enterprise and the extent of the creditors' detriment.[102]

[102] Decision of the Supreme Court, dated January 13, 2010, II CSK 364/09, Decision of the Supreme Court dated December 12, 2008, IV CSK 379/08.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue

6.1.1 The company as plaintiff

Only the company is entitled to file a law suit based on art. 483 CCC. Pursuant to art 393.2 CCC, the shareholders' meeting releases a resolution concerning claims for redress of damage caused upon formation of the company or in the course of management. A different regulation in the company's articles would be forbidden.[103] A resolution concerning liability of members of company's governing bodies is made in a secret voting (art. 420 § 2 CCC) and requires an absolute majority to pass. Even if the director had the company's shares and theoretically could vote, art. 413 CCC explicitly excludes him or her from voting. Should it come to the judicial proceeding, the company may be represented either by the supervisory board or by a special attorney appointed by the shareholders' meeting.

The burden to prove the lack of fault rests with the director.[104] The company has to prove that the damage occurred and establish the causal link.[105] As already mentioned, directors cannot justify their action by claiming that their action lay within the risk of conducting economic activities, if the damage was caused by negligence in handling the company's affairs. But such risk can be taken into account to evaluate the circumstances that could lead to the restitution of the damage.[106] A manager in a joint-stock company does not have the possibility to argue that he or she merely executed the resolution of the shareholder's meeting,[107] because the management board is independent in its actions.

If the company would seek redress of the damage, a claim for redress would be barred by limitation after three years from the date on which the company learned of the damage and of the person liable to redress it. However, in any case, the claim shall be barred by limitation after five years from the date of the event which caused the damage (art. 488 CCC).

Pursuant to art. 118 of the Civil Code, unless a specific regulation provides otherwise, the limitations period for tort based claims is ten years and for claims concerning periodical performances and claims connected with conducting business activity it is three years.

The abovementioned limitation periods will be of relevance depending on the basis of a claim against the director.

[103] J. Szwaja [in:] S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. III, Warszawa 2008, p 875.
[104] R. Szczęsny, *Odpowiedzialność odszkodowawcza członków zarządu*, Pr. Sp. 2007, No. 3 p. 22; W. Popiołek [in:] J. Strzępka, *Kodeks spółek handlowych. Komentarz*, Warszawa 2012, p. 1184; R. Cierpial [in:] S. Kalss, *Vorstandshaftung in 15 europäischen Ländern*, Vienna 2005, p. 671.
[105] W. Popiołek [in:] J. Strzępka, *Kodeks spółek handlowych. Komentarz*, Warszawa 2012, p. 1184.
[106] Judgment of Supreme Court of May 9, 2000, IV CKN 117/00.
[107] A. Szajkowski [in:] S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. IV, Warszawa 2004, p. 153.

6.1.2 The shareholders as plaintiffs

6.1.2.1 In the name of the company ('derivative action')

In case the company fails to bring an action for redressing damage within the year, art. 486 CCC provides for a possibility of a derivative suit brought by any shareholder or a person otherwise entitled to participate in the profit or in the distribution of the company's assets.[108] A derivative action is brought in the name of shareholder for the company[109] within a year from the disclosure of the injurious act. The plaintiff must prove the damage, abuse on the part of director and a causal link between abuse and damage.[110] Should a derivative action be brought against the director, he or she cannot defend themselves by invoking a resolution of the shareholder meeting acknowledging their fulfillment of duties or a waiver of the company's claim for damage (art. 487 CCC). A derivate action does not present an efficient tool to redress the company's damage and in practice its role is minimal. There are not many advantages for a person who brings a derivative action as well as an information asymmetry which makes it harder for a shareholder to bear effectively the burden of proof. At the demand of the defendant made upon the first action in the course of the proceedings, the court may order that bail be paid to secure the damage which may be sustained by the defendant. The court determines the amount and type of bail at its discretion. Where the bail is not paid within the time limit specified by the court, the writ shall be dismissed (art. 486.2 CCC). There is also a risk that the court orders the plaintiff to redress the damage caused to the defendant, if it finds the action to be unfounded and the plaintiff acted in bad faith or flagrant negligence when bringing the action, the plaintiff shall be obligated (art. 486.4. CCC).

6.2 Criminal and administrative sanctions

6.2.1 Penal liability under CCC

An Act dated 12 July 2011[111] abrogated art. 586 of the CCC. This provision stipulated that a person who, while participating in the creation of a commercial company or serving as a member of its management board, supervisory board or audit committee or as a liquidator, acted to the detriment of the company was to become subject to a penalty of imprisonment for up to five years and a fine. According to § 2 of this article, a person who incited a person listed in § 1 to act to the detriment of the company or aids and abets him in committing this crime shall be subject to the same penalty. However, the legislator decided to leave in the CCC a set of penal rules which specifically address misconduct members of the management board.

In the context of bankruptcy procedure, it needs to be noted that art. 586 CCC contains penal regulation in regards to directors who, while serving as a member of the management board of a company, fail to file for the bankruptcy despite the existence of circumstances justifying bankruptcy of the company in accordance with the relevant provisions of LBR. In such a case, directors may be subjected to a fine, a penalty of restriction of liberty or imprisonment for up to one year.

[108] For instance: holders of bonds giving the right to participate in company's profit).
[109] A. Szajkowski [in:] S. Sołtysiński, A. Szajkowski, A. Szumański, J. Szwaja, *Kodeks spółek handlowych. Komentarz*, vol. IV, Warszawa 2004, p. 155.
[110] See judgment of the Supreme Court of February 9, 2006, V CK 128/05.
[111] Dz. U. 2000 No. 94, Pos. 1037.

Also a director who in the course of performance of the duties set out in Title III, concerning the commercial companies and Title IV concerning merger, division and transformation of the companies, announces false data or submits it to the company's governing bodies, government agencies or to a person authorised to carry out an audit, shall be subject to a fine, a penalty of restriction of liberty or imprisonment for up to two years (art. 587 § 1 CCC). However, if the court finds that the act was unintentional, the time of maximum imprisonment is limited to one year (art. 587 § 2 CCC).

According to art. 588 CCC a person who, while serving as a member of the management board allows a commercial company to acquire its own shares or accepts them as a subject of a pledge shall be subject to a fine, a penalty of restriction of liberty or imprisonment for up to six months.

A person who, while serving as a member of the management board or a liquidator of a limited liability company, allows the company to issue registered documents, documents to the bearer or documents to an order for shares or rights to profits in the company shall be subject to a fine, a penalty of restriction of liberty or imprisonment for up to six months (art. 589 CCC).

A member of the management board who allows that share certificates are issued: (i) which are not fully paid for, (ii) prior to registration of the company, (iii) in the case where the share capital is increased, prior to registration of the increase, shall be subject to a fine, a penalty of restriction of liberty or imprisonment for up to one year (Art. 592).

Article 594 CCC sets a list of failures of members of the management board that can be sanctioned by a person who, while serving as a member of the management board of a commercial company, in breach of his duty, allows the management board:

1) To fail to file with the registry court a list of the shareholders;

2) To fail to keep a share register in accordance with the provisions of Article 188 § 1 or a share register in accordance with the provisions of Article 341 § 1;

3) To fail to convene a general meeting or a general assembly;

4) To refuse to give explanations to a person authoriSed to carry out an audit or prevents such a person from carrying out his duties;

5) To fail to apply to the registry court for auditors to be appointed; and

6) To fail to announce that the auditor submitted an opinion to the registry court in accordance with the provisions of Article 312 § 7 CCC;

shall be subject to a fine of up to 20,000 PLN.

Also a person shall be subject to the same fine if while serving as a member of the management board, allows the company, in breach of the law or the articles, not to have a supervisory board of a proper composition for more than three months.

A director, while serving as a member of the management board of a capital company, allows that the written communications and orders, as well as the information referred to in Article 206 § 1 CCC and Article 374 § 1 CCC, do not include the particulars set out in these provisions or, while being a general partner of a limited joint-stock partnership entitled to represent the partnership, allows that the written communications and orders, as well as the information referred to in Article 127 § 5 CCC do not include the particulars set out in these provisions - shall be subject to a fine of up to 5.000,00 PLN.

6.2.2 Penal liability under Penal Code

The Polish Penal Code[112] provides in Title XXXVI several provisions concerning crimes against the economic circulation. The regulations of the Penal Code were designed to supplement the provisions of the Code of Commercial Companies and Civil Code. The Penal Code took over the provisions of the lifted Act on Protection of Economic Circulation.

At present, Poland faces a broader discussion that could eventually lead to a reform on the field of penal sanctions in commercial setting. At present, Polish law contains over three hundred provisions that concern offences that can occur in relation to business activity.[113] Some of them are similar, for instance, the penal provisions in Code of Commercial Companies and provisions of the Penal Code. According to Police statistics, approximately 150.000 business-related crimes took place in 2011.[114] The main concern is that business decision-making process should not be slowed down by mere uncertainty of law. Over fifty Acts contain provisions relating to business activities with an extensive penal liability. There is a common understanding that at present penal liability concerning business activities is overregulated. According to the Ministry of Justice which works on the reform, forty provisions should suffice. Therefore, the field of reinforcement is planned to be shifted from penal to administrative measures. However the latter proposition is still the subject of controversy. It should be expected that the changes will also take place in the penal section of the Code of Commercial Companies and that there will be changes to the regulation of directors' liability.

The following offences can be pursued in the criminal litigation: obstruction of pursuit of claims in case of insolvency (art. 300 PC), formation of a new company in order to move the assets from the bankrupting company (art. 301 §1 PC) and intended insolvency (art. 301 § 1 CP). Money laundering is punishable under art. 299 PC, as well as an Act on Counteracting the Putting on the Market of Assets of Hidden Origin and on Counteracting the Terrorism. Also circulation of false data can lead to penal liability under art. 311 CP.

[112] Dz. U. 1997, No. 88, Pos. 553.
[113] Agata Łukaszewicz, *Ograniczenie kar ma rozruszać gospodarkę* [in:] Rzeczpospolita 14 March 2012, available at: http://www.rp.pl/artykul/758347,838084-Mniej-kar-ma-rozruszac-gospodarke.html last accessed 10.4.2012.
[114] Agata Łukasiewicz, Biznes to nie kryminał [in:] Rzeczpospolita 14 March 2012, available at: http://www.rp.pl/artykul/758347,838123-300-przepisow-karnych-czeka-zmiana-lub-likwidacja.html. Last accessed 10.4.2012.

7 CONFLICT OF LAWS

7.1 Classification under Polish private international law

7.1.1 Company law

Polish Private International Law, dated February 4, 2011,[115] contains regulations on legal entities in chapter 3 of the statute. Pursuant to art. 17 § 1 PIL, the law of the country where a legal person has its seat applies. If law mentioned in art. 17 § 1 PIL, establishes that the relevant law for the legal person will be the law of the country in which the legal person was created, the law of the latter should be applicable, art. 17 § 2 PIL). These rules apply especially, but not exclusively (open catalogue) to: formation, merger, division, transformation or liquidation of a legal person, legal nature of a legal person, name and firm of a legal person, legal capacity of a legal person, competences and operational rules as well as appointment and dismissal of the members of the company's bodies; representation; acquiring and loss of the statues of a shareholder or member as well as rights and duties connected with this status; liability of shareholders or members of a legal person for its obligations; consequences of the violation of the statutory provisions or articles of association by a person who is representing a legal person.

In the attempt to regulate the provisions concerning legal entities, the legislator decided to conciliate two basic theories: the seat theory and the formation theory without specification of how the seat of a legal person should be understood.[116] This matter was left for the jurisprudence and the legal doctrine to resolve – and resolved in critique of the legislator's choice. [117] However, the interpretation in accordance with community law as well as teleological and systematic interpretation lead to a conclusion that the connector of the registered seat of the company should be used in order to establish applicable law and not the factual seat of the company.[118]

7.1.2 Tort law

According to art. 33 of Polish Private International Law Act (PIL) dated February 4, 2012, the law applicable to events that cannot be qualified as an act in law, are governed by the provisions of the Regulation (EC) No 864/2007/WE of the Parliament and of the council of July 11, 2007 on the law applicable to non-contractual obligations (Rome II).

Additionally, Poland is a party to many bilateral conventions which provide for norms resolving law collision for illegal acts or non-contractual obligations (for instance a convention with Russia, Belarus, Ukraine, Vietnam).[119] The most common connector is the place of the event that is the source of an

[115] Dz. U. 2011, No. 80, Pos. 432.
[116] M. Pazdan, *Prawo międzynarodowe prywatne*, Warszawa 2012, p. 110; K. Oplustil, *Łącznik siedziby spółki w nowym prawie prywatnym międzynarodowym. Uwagi na tle prawa europejskiego*, KPP 2011, No. 3, p. 635.
[117] K. Oplustil, *Łącznik siedziby spółki w nowym prawie prywatnym międzynarodowym. Uwagi na tle prawa europejskiego*, KPP 2011, No. 3, p. 679.
[118] K. Oplustil, *Łącznik siedziby spółki w nowym prawie prywatnym międzynarodowym. Uwagi na tle prawa europejskiego*, KPP 2011, No. 3, p. 679.
[119] M. Pazdan, *Prawo międzynarodowe prywatne*, Warszawa 2012, p. 304.

obligation.[120] Only several conventions would rely solely on this connector. Most of them provide for supplementary ones such as the shared citizenship of the parties to the obligation.[121]

Pursuant to Art. 28.1 of Rome II, the Regulation does not prejudice the application of international conventions to which one or more Member States are parties at the time when this Regulation is adopted and which lay down conflict-of-law rules relating to non-contractual obligations (it however proceeds over conventions concluded exclusively between two or more Member States – as far as these conventions cover matters regulated in this regulation).

7.1.3 Special duties in the vicinity of insolvency

Provisions of Private International Law do not provide for regulations identifying relevant law of manager's duties in the vicinity of insolvency. Depending on their conduct, the provisions would either tend to follow the rules on regulating the relevant law of tort of the one applicable to companies.

7.2 Application of the relevant private international law rule

According to art. 17 § 1 of Polish Private International Law Act (PIL), the law applicable to the legal person is the law of the country in which the legal person has its seat. If the law of the country specified in § 1 established the jurisdiction of the country under which law the legal person was formed, then the law of the latter should apply (art. 17 § 2 PIL). These rules are applicable also to:

- Formation, merger, division, transformation or liquidation of a legal person;
- Legal nature of a legal person;
- Name and firm of a legal person;
- Legal capacity of a legal person;
- Competences and operational rules as well as appointment and dismissal of the members of company's bodies;
- Representation;
- Acquiring and loss of the statues of a shareholder or member as well as rights and duties connected with this status;
- Liability of shareholders or members of a legal person for its obligations; and
- The consequences of the violation of the statutory provisions or articles of association by a person who is representing a legal person.

Depending on the character of violations of directors' duties one could consider applicability of law under the provisions of PIL for the tort law or for the company law.

[120] M. Pazdan, *Prawo międzynarodowe prywatne*, Warszawa 2012, p. 304.
[121] M. Pazdan, *Prawo międzynarodowe prywatne*, Warszawa 2012, p. 305.

DIRECTORS' DUTIES AND LIABILITY IN PORTUGAL

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CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in Portugal

The Portuguese legal system is a civil law system based on statutory rules as the primary source of law. Traditionally, the main areas of law are unified in codes and complemented by other pieces of legislation. Case law plays an auxiliary role by supporting and giving guidance on the interpretation and application of the laws. In relation to directors' duties and liability, court decisions are relatively rare, but the academic work in this field is quite relevant and usually taken into consideration by the courts.

The legal foundations of directors' duties and liability can be found in different areas of law. The key legal provisions are contained in the Code of Commercial Companies ("*Código das Sociedades Comerciais*"):[1] the core legal provisions are Article 64 (concerning the fundamental duties of care and loyalty of the directors of a company) and Articles 72 ff. (concerning the liability of directors towards the company as well as shareholders and creditors). These provisions are applicable to all types of commercial companies, including private and public limited liability companies, listed and non-listed companies and state-controlled enterprises.

It should be noted that in 2006 a major reform of the Portuguese Code of Commercial Companies was adopted.[2] The material amendments might be summarised as follows: Article 64, which contains the fundamental duties of directors, was redrafted; a new model for the governance of the stock corporation was introduced; corporate acts were simplified and de-formalised (e.g., the need for a public deed for the incorporation of a company was eliminated); and finally, the reform established a new regime for the dissolution and winding-up of companies and new concepts regarding the stock corporation (such as "large company" and "independent member" of the corporate bodies).[3]

In addition to the key provisions of the Code of Commercial Companies, certain types of companies may be subject to specific rules. For instance, listed companies are governed by the *Securities Code* of 1999 and the "Code of Corporate Governance" of 2010 approved by the Portuguese Securities Market Commission (CMVM) (complemented by Regulation CMVM nº. 1/2010).[4] The Code of Corporate Governance is a statement of best practice, which includes, among others, rules on the composition of the board of directors of companies with publicly traded securities. Whilst the code itself is not binding, the "comply or explain principle" is applicable and, thus, listed companies are required to publish a declaration whether they have applied these rules and, if not, give reasons for their non-compliance.[5]

[1] Enacted by the Decree-Law nº. 282/86, of 2 September).
[2] Enacted by Decree-Law no. 76-A/2006, of 29 March.
[3] José Engrácia Antunes, *Direito das Sociedades,* 34 and f. (Porto, 2012); António Menezes Cordeiro, *A Grande Reforma das Sociedades Comerciais*, in: 138 "O Direito" (2006), 445-453.
[4] A corporate governance code for non-listed companies is under preparation by the Portuguese Corporate Governance Institute.
[5] Paulo Câmara, *Códigos de Governo das Sociedades,* in: 15 "Cadernos do Mercado de Valores Mobiliários" (2002), 65-90.

The business sector or activity of the company may also determine the application of other specific legislation. This is the case, for example, for banks, insurance and investment companies whose activities are governed by the abovementioned provisions, as well as by specific pieces of legislation and rules imposed by the respective supervising authority.

Finally, specific legal provisions applicable to company directors may be also found in the *Code of Insolvency* of 2004 (Articles 49(2)(c) and 186) and in the *Criminal Code* of 1982 (Articles 277 to 229).

1.2 Corporate landscape in Portugal

As in many other European legislations, Portuguese law is based upon a fundamental division between two basic sets of companies: *civil companies* ("sociedades civis") and *commercial companies* ("sociedades comerciais").

The *civil company* is defined in the *Civil Code* of 1966 as a contract between two or more persons (individuals or legal persons) who contribute goods (cash or in kind) or services in order to enter jointly into a profit-making civil economic activity (art. 980º CC).[6] Examples of these civil companies are partnerships of liberal professions such as those involving attorneys, auditors, physicians, artists, or engineers. All partners are personally and jointly liable for the company's debts. However, while the members can be sued directly by the company's creditors, they may request the prior exhaustion of the company's assets (Article 997 of the Civil Code).

As mentioned, *commercial companies* are regulated in the Code of Commercial Companies of 1986. By regrouping dispersed and ancient legislation, this Code aims at providing a global and systematic regulation of commercial companies: it contains a set of legal provisions which are applicable to all types of companies (Part I), as well as specific regulations for each one of the different legal types (Part II to Part V) – with a particular emphasis on stock corporations (Part IV, Articles 271 to 464) –, and rules concerning affiliate companies (Part VI, Articles 481 to 508-E). The Code adopts some original solutions from a comparative law perspective, but it has been profoundly inspired by a number of foreign legal orders (mainly, the German and French company laws). It also takes into account the European Directives on company law, including some which have not been finally approved, such as the proposal for a 9th Directive on Groups of Companies. Thus, Portugal may be considered as an example of a "transplant country", that is, a legal order largely inspired or even based upon foreign legal models.[7] It may also be argued that it suffers from the "petrification syndrome", which is currently noticed in several EU Member States in consequence of the binding subordination of their legal orders to a system of harmonisation through the use of Directives.[8]

Article 1 of the Portuguese Code of Commercial Companies sets forth four types of companies to carry out a mercantile business in Portugal: (i) general partnership ("*sociedade em nome colectivo*") (Articles 175 to 196); (ii) limited liability company ("*sociedade por quotas*") (Articles 196 to 270); (iii)

[6] Unlike the German "Gesellschaft bürgerlichen Rechts", these civil law companies are prohibited from pursuing non profit-making activities. In contrast to the Italian "società semplice", some may enjoy a legal personality of their own.
[7] On this distinction between "origin countries" (that is, countries that developed their formal legal system with very limited borrowing from external models) and "transplant countries" see Katharina Pistor, Yoram Keinam, Jan Kleinheitsterkamp & Mark, West, *Innovation in Corporate Law*, 5, available at: http://ssrn.com/abstract=419861.
[8] On this petrification problem see "Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe", 31, Brussels, 2002.

stock corporation ("*sociedade anónima*") (Articles 271 to 464); and (iv) limited partnership ("*sociedade em comandita*"), either simple or by shares (Articles 465 to 480).

No doubts exist as to the predominant role played by commercial companies: according to a survey of 2010, the *limited liability company* is the most widespread legal type (387.534), followed at some distance by *stock corporations* (30.257), *general partnerships* (1.157), and *limited partnerships* (55). By contrast, the number of *civil companies* (1.448) is comparatively low.[9]

Therefore, limited liability companies and stock corporations are by far the most common types of Portuguese commercial companies. The majority of small and medium-sized Portuguese companies are limited liability companies, and the larger ones adopt the form of the stock corporation.[10]

To give an overview of the less common types of commercial companies, in a *general partnership* each shareholder is liable for his own contribution and all the shareholders are jointly liable for the corporate debts, but such liability is subsidiary in relation to the company (Code of Commercial Companies, Article 175). There are no minimum capital requirements. In the *simple limited partnership* at least one member is subject to unlimited personal liability for the partnership's obligations (general partner), while the other members are only liable for the amount of capital individually subscribed to (limited partners) (Code of Commercial Companies, Article 465). The managing function is performed by the general partners (Code of Commercial Companies, Article 470). There are no minimum capital requirements. Lastly, the *limited partnership by shares* has the same liability characteristics as the limited partnership (one or more general partners who have unlimited personal liability and perform managing functions, as well as limited partners), but the contributions of the limited partners are divided into shares (Code of Commercial Companies, Article 478). The minimum share capital is € 50,000.

Turning to the most common types of commercial companies, in *limited liability companies* the share capital is freely determined by the shareholders and is divided into parts ("*quotas*"). The shareholders are jointly liable for the contributions agreed in the articles of association. However, only the corporate assets answer for the company's debts (Code of Commercial Companies, Article 197). The flexibility of this type of company is limited by the legal requirements applicable to the transfer of quotas (as a general rule, the transfer of quotas depends on the company's prior consent and only produces effects towards the company after written communication). The corporate structure is simplified: the general shareholders' meeting, one or more directors and, under specific circumstances, an auditing board or a chartered accountant may be required (Code of Commercial Companies, Articles 246, 252 and 262).[11] Portuguese law also enables the so-called "one man company", that is, the incorporation of a limited liability company by a single shareholder (Code of Commercial Companies, Article 270-A).

[9] Data collected from the National Institute of Statistics, 2010.
[10] The distinction between these two legal forms (limited liability company and stock corporation) does not necessarily coincide with the distinction between "public" and "private" companies: there are stock corporations who are not listed and do not have a large number of widely dispersed shareholders (e.g., family-owned enterprises), whereas some limited liability companies may have a greater number of shareholders, employees and turnover than many stock corporations.
[11] This is the case if the company's articles provide for an auditing board or chartered accountant or if the company surpasses, during two subsequent years, two of the following limits: *i)* total balance sheet amount of € 1,500,000; *ii)* total amount of net sales or other incomes of € 3,000,000; *iii)* or an annual average of at least 50 employees (Code of Commercial Companies, Article 262(2)).

1.3 The board of a Portuguese company

In the *stock corporation* (“*sociedade anónima*”) the share capital is divided into shares (*“acções”*) and should amount to a minimum of € 50,000 (Code of Commercial Companies, Article 276). Each shareholder’s liability is limited to the amount corresponding to his contributions and only the corporate assets answer for the company’s debts (Code of Commercial Companies, Article 271).

Portuguese law provides for three different and alternative models of management and control of a stock corporation. Under Article 278 of the Code of Commercial Companies, shareholders might choose one of the following legal models: (i) the Latin or classic model, which comprises a board of directors (or a sole director if the company’s share capital does not exceed € 200,000) and a sole auditor or an audit board;[12] (ii) the Anglo-Saxon model, which consists of a board of directors, including an audit committee, composed of non-executive directors, and a chartered accountant; and (iii) the German or dualist model, which includes an executive managing board (or a sole director if the company’s share capital does not exceed € 200,000), a general and supervisory board and a chartered account. The Latin model is the most common model used by non-listed companies, while listed companies usually adopt the Anglo-Saxon or the German model. Portuguese law enables the incorporation of a stock corporation by a sole shareholder as long as this shareholder is another stock corporation or a limited liability company. Special rules apply to these wholly-owned subsidiaries (Code of Commercial Companies, Articles 488 to 491).

Stock corporations may be listed on NYSE Euronext Lisbon (the Portuguese Official Listing Market). Only the largest Portuguese companies use capital markets to raise funds.[13] The Corporate Governance Code contains specific rules on the composition of the board of directors of listed companies.

Traditionally, Portuguese companies are characterised by a concentrated ownership structure. Large blocks of shares are held by families, banks or other companies. The State used to exert a great influence through the ownership of companies in key sectors, such as electricity, water, airlines and post office services, but we are now witnessing a reverse tendency.[14] This ownership pattern is evidenced by data available for listed companies.[15]

[12] Stock corporation issuers of securities admitted to trading on a regulated market and “large companies by shares” must have an audit board and a chartered accountant or a chartered accountant company which does not belong to the audit board (Code of Commercial Companies, Article 413(2)). According to the same provision, “large companies by shares” are those which, for two consecutive years, exceed one of the following limits: *i)* total balance sheet of € 100,000,000; *ii)* total of net sales or other incomes of € 150,000,000; *iii)* or average number of employees during the financial year of 150.

[13] NYSE Euronext Lisbon currently has a total of 51 listed companies (excluding investment funds) – 46 domestic and 5 foreign – with a market capitalization of € 47,520,000,000 as of 31 December 2011 <https://europeanequities.nyx.com/en/markets/nyse-euronext/lisbon> accessed 17 February 2012.

[14] Currently, the State’s ownership is being reduced as a result of the Memorandum of Understanding on the financial assistance granted by the European Union. Indeed, Portugal undertook to accelerate its privatization program. Such privatization will include transport (*Aeroportos de Portugal*, *TAP*, and the freight branch of *CP*), energy (*GALP*, *EDP*, and *REN*, all listed companies), communications (*Correios de Portugal*), insurance (*Caixa Seguros*), as well as a number of smaller firms <http://ec.europa.eu/economy_finance/eu_borrower/mou/2011-05-18-mou-portugal_en.pdf> accessed 17 February 2012.

[15] According to the corporate governance report issued by the Portuguese Securities Market Commission (hereinafter referred to as “CMVM”) in 2011, “*by the end of 2009, 218 qualifying holdings were identified in the 45 companies analysed, representing 75.6% of the share capital of the companies. Taking into account the qualifying holding criterion in Article 9 of the Transparency Directive which determines a 5% share capital of the company as the minimum of the qualifying holding, 140 qualifying holdings within the 45 analysed companies represented 70.4% of the share capital*”. As to the type of investor, “*qualifying holdings were mostly held by Qualified Investors (74.8%). The State represented 6% of the number of qualifying holdings and the remainder (19.3%) was held by other types of investors*”; see <http://www.cmvm.pt/EN/Estudos/Documents/Final.Corporate.Governance.Report.2011.pdf> accessed 17 February 2012.

In Portugal, employees do not enjoy a general right to participate in the management of commercial companies. In specific procedures, such as mergers, employees enjoy certain rights (for instance, to consult documentation and to issue an opinion).

Under Portuguese law, directors have an exclusive power to manage the company's affairs (Code of Commercial Companies, Articles 405 and 406), and the General Meeting of shareholders can only decide on matters which are explicitly assigned to them by law or by the articles of association , e.g., appointment and removal of, or legal actions against, members of other corporate organs, amendment of the articles of association, major structural changes (such as mergers, divisions, creation of groups, dissolution), approval of annual accounts, distribution of profits, redemption and repurchase of shares, and many others (Code of Commercial Companies, Article 373(2)). Moreover, shareholders cannot give binding instructions to the directors concerning the management of the company, and may only decide on such matters upon the request of the directors themselves (Code of Commercial Companies, Article 373(3)).

2 The concept of 'company director' in Portugal

2.1 De iure directors

Before explaining the legal regime of directors and their liability in Portugal, it is necessary to clarify the legal terminology: whereas in stock corporations, the organ responsible for the management of the company is the board of directors ("Conselho de Administração") – whose members are the *directors* ("administradores") –, in the limited liability companies the same organ is simply called "Management" ("Gerência") and its members are the *managers* ("gerentes"). In spite of this terminological difference, we shall refer afterwards indistinctly to *directors*.

2.1.1 Requirements to become a *de iure* director

In order to become a *de iure* director, a person has to be appointed by the shareholders (in the articles of association or the general meeting by simple majority) and accept, expressly or implicitly, to hold the office (Code of Commercial Companies, Article 391(1) and (5)). Neither the employees nor their representatives play a role in the appointment of directors. Although appointed for a specified period (maximum of 4 years), the director will remain in office until the appointment of a new member, provided he is not dismissed or renounces the office (Code of Commercial Companies, Article 391(3) and (4)).

2.1.2 Who can be a *de iure* director

Any individual person with full legal capacity – thus, minors, incapacitated, and insolvent individuals are excluded – shareholder or not, may be elected as director of a company (Code of Commercial Companies, Article 390(3)). A legal person (such as a company) may serve as director as well. However, as the director's capacity is *intuitus personae*, the legal person must appoint an individual to exercise the office. The director is the individual person, not the legal person. The legal person is jointly and severally liable for the director's acts (Code of Commercial Companies, Article 390(4)).

The number of members of the board of directors or the executive board of directors is fixed in the articles of association (Code of Commercial Companies, Articles 390(1) and 424).

There are also rules concerning the composition of the supervision and auditing organs of the company. The audit committee consists of the number of members as laid down in the Articles, but it must have at least three effective members (Code of Commercial Companies, Article 423-B(2)). The number of members of the general and supervisory board is determined in the Articles, but its number must always be higher than the number of executive directors (Code of Commercial Companies, Article 434(1)).

The Corporate Governance Code also contains specific provisions in this regard. For example, the number of non-executive members shall ensure the efficient supervision, auditing and assessment of the executive members' activities (recommendation no. II.1.2.1.); the non-executive members must include an adequate number of independent members, considering the size of the company and its shareholder structure; and the number of independent members shall never be less than one-fourth of the total number of directors (recommendation no. II.1.2.2.).

2.2 De facto and shadow directors

According to the Code of Commercial Companies, "the legal provisions regarding the directors' liability are applicable to other individuals to whom management functions are given" (Article 80). Other express references to *de facto* directors can be found in other pieces of legislation: the Code of Insolvency contains a list of situations in relation to the conduct of *de iure* or *de facto* directors which lead to the qualification of the insolvency as fault-based (Articles 49(2)(c), 82(2)(a), and 186); and the types of behaviour described in the Criminal Code, Articles 227 to 229, are considered as criminal offences if displayed by *de iure* directors or by those who actually manage the company.

It is increasingly accepted in the literature and case-law that the abovementioned provisions are applicable to any person who, without sufficient title, performs in an autonomous way, either directly or indirectly, functions usually performed by *de iure* directors.[16] Although the distinction between *de facto* and shadow directors is not made by all commentators, some express references as to their subjection to director's duties and liability can be found.[17]

2.3 Directors in groups of companies

Somewhat similar to German law, the Portuguese Code of Commercial Companies provides a set of rules concerning affiliated companies ("sociedades coligadas"), in particular groups of companies (Articles 481.º to 508-A).[18] In a general sense, this regulatory framework seems to be based on a clear-cut distinction between two different legal models for the organisation of groups of companies (legal versus factual groups).

Legal groups are clusters of companies where the parent company holds a 100% shareholding in a subsidiary company (wholly-owned subsidiary) or has a subordination agreement with it. In such a case, the parent company enjoys a broad legal power of direction over the management of the affairs of the subsidiary (Article 493 of the Code of Commercial Companies): in particular, directors of the parent have the right to give binding instructions to the board of directors of the subsidiary, including instructions which are prejudicial or contrary to the interest of the latter insofar as such instructions

[16] Ricardo Costa, *A Responsabilidade Civil Societária dos Administradores de Facto*, in: "Temas Societários", nº 2, 23-43, Idet, Coimbra, 2006; see also the sentence of the Supreme Court of Justice of 13-9- 2007, in: XV "Colectânea de Jurisprudência" (2007), III, 48-50. Moreover, it is worth noting that during the process of public consultation prepared by CMVM regarding the reform of the Code of Commercial Companies, the Portuguese CMVM analyzed the problem of *de facto* directors and its eventual express legal recognition. However, it was argued that the legal framework already foresaw legal rules which made reference to de facto directors. This meant that the legal rules applicable to *de iure* directors were implicitly applied to *de facto* directors and, thus, no express reference was required.

[17] Jorge Manuel Coutinho de Abreu/Elisabete Ramos, '*Responsabilidade civil de administradores e de sócios controladores*' (no. 3, Instituto de Direito das Empresas e do Trabalho, Almedina, 2004) 40 and subsequent.

[18] See José Antunes, *The Law of Corporate Groups in Portugal.* Institute for Law and Finance, University of Frankfurt, Working Paper Series nº 84, 2008.

may serve the interest of the parent corporation or other group affiliates (Article 503(2) of the Code of Commercial Companies). This power of direction, however, is not unlimited: the parent company may issue instructions only in matters related to the management of the subsidiary (being prohibited to do it in matters for which any other subsidiary organ, e.g. the general meeting, is competent: cf. Article 493(1) Code of Commercial Companies); it may not issue instructions which are illegal from the viewpoint of other branches of the law, e.g., labour law, tax law (Article 503(2) Code of Commercial Companies) or from the viewpoint of the articles of association of the subsidiary company; and it may not issue instructions on intragroup transfers of assets without appropriate compensation (Article 503(4) Code of Commercial Companies). In return, the law establishes a system of protection for subsidiary companies, their minority shareholders, and creditors by imposing on the parent company a duty of covering the annual losses of the subsidiary (Article 502 of the Code of Commercial Companies), a direct joint liability for the settlement of subsidiary debts (Article 501 of the Code of Commercial Companies), and a duty of compulsory acquisition of the shares of the subsidiary's outside shareholders (Article 494 of the Code of Commercial Companies).

Where no 100% shareholding or subordination agreement exists and the group organisation is based on other types of intercompany linkages (e.g., majority shareholdings), one speaks of a *factual group*. In such a case, the parent company exercises a mere "de facto" power of control over the affairs of its subsidiaries: that is, parent directors enjoy no right of issuing binding instructions to the subsidiary and are prevented from exerting a dominating influence which is contrary or prejudicial to the interest of the latter (Article 64 Code of Commercial Companies).

3 THE SCOPE OF DIRECTORS' DUTIES UNDER PORTUGUESE LAW

3.1 Types of directors' duties

In Portugal, directors are seen as *fiduciaries*. By assuming the responsibility and empowerment to act on behalf of another person, the directors enter into a fiduciary relationship.[19] Due to such fiduciary relationship, there is the need to delineate duties to constrain their discretion and to impose behavioural expectations. The authority of directors and the legal grounds for their duties are clearly and directly defined in the statute. The directors' authority and decision-making power are original.

Until 2006, the Portuguese legal framework did not contain an explicit regime regarding the duties applicable to directors.[20] In 2006, pursuant to a major reform of the Portuguese Code of Commercial Companies,[21] Articles 64 and 72(2) were amended in the following terms:

Article 64 – Fundamental Duties

1 – The directors of companies must comply with:

a) Duties of care, displaying willingness, technical competence and an understanding of the company's business that are appropriate to their role, and executing their duties with the diligence of an orderly and responsible manager; and

b) Duties of loyalty to the interests of the company, promoting the long term interests of the shareholders, and taking into account the interests of other stakeholders relevant for the sustainability of the company, such as its employees, clients and creditors.

2 – Members of the corporate bodies with supervisory/auditing powers must observe duties of care, by employing high standards of professional diligence, and duties of loyalty in the interests of the company.

Article 72 – Liability of Directors towards the Company

1 – The managers or directors shall be liable for damages caused by acts or omissions performed in breach of their legal or contractual duties, unless the managers or directors can prove that they did not act wilfully or maliciously.

2 – This liability shall be waived if any of the persons to which the previous paragraph refers is able to prove that he or she acted in an informed manner, free of any personal interest and using the criteria of corporate rationality.

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[19] Ricardo Costa/Gabriela Figueiredo Dias, *Código das Sociedades Comerciais em Comentário*, (volume I, Almedina, 2010) 726 to 727; Manuel Carneiro da Frada, 'A business judgement rule no quadro dos deveres gerais dos administradores', in: Revista da Ordem dos Advogados (2007) (I) <http://www.oa.pt/Conteudos/Artigos/detalhe_artigo.aspx?idc=30777&idsc=59032&ida=59045> accessed 17 February 2012.

[20] Article 64 of the Code of Commercial Companies in force at the time, under the title "*Duty of Care*", stipulated that "*[t]he directors and officers of a company shall act with the care of a diligent and ordered manager, in the interest of the company, considering the interests of shareholders and employees*".

[21] See above 1.1.

3 – Likewise, managers and directors who did not participate in a collegiate resolution of the managers or directors, or whose votes were overridden, shall not have equal liability. In this case, the said managers and directors shall have five days to cast their ballot, either in the book of minutes or in a notice submitted to the supervisory body, if such a body exists, or before a notary or registrar.

4 – A manager or director who does not exercise their right of opposition, as conferred by law, when able to do so, shall be jointly liable for the acts they could have objected to.

5 – Managers or directors shall not be answerable towards the company if the act or omission is part of a resolution adopted by the partners, even if this resolution is voidable.

6 – In companies that have a supervisory body, the favourable opinion or consent of this body shall not release the members of the board from liability.

Article 73 – Joint and Several Liability

1 – Founders, managers and directors are jointly and severally liable.

2 – The right to objection exists in the same measure as the respective culpability and the consequences thereof, the culpability of the persons responsible being considered equal.

Portuguese law contains two main types of duties that are clearly distinguished: the duty of care and the duty of loyalty. The *duty of care* is based on general standards of conduct imposed on directors when managing the company's affairs (which are not part of the law of negligence).[22] *The duty of loyalty* is based on the idea that as directors manage third parties' assets, good faith requires a behaviour which aligns the directors' interests with the interests of the third parties by imposing standards of loyalty.[23]

The wording of Article 64 has been strongly criticised by some Portuguese commentators because it seems that the legislator mixed different concepts and created a confusing provision which makes little sense in certain respects. This seems to be a result of a juxtaposition of influences from different origins and times: a traditional Portuguese influence regarding the care of a diligent and organised manager; a German influence regarding the duty of loyalty; a European influence due to the references to the interests of the company, the shareholders, and employees; and finally, an Anglo-Saxon influence concerning the distinction between care and loyalty, the inspiration of the business judgment rule, and the reference to the interests of stakeholders.

The duties of care and loyalty apply cumulatively and, thus, directors must always comply with both duties (Code of Commercial Companies, Article 64(1)).

[22] This understanding about the nature of the duties was adopted by the Supreme Court in judgment no. 94/07.8TYLSB.L1.S1, 17 September 2009. <http://www.dgsi.pt/jstj.nsf/954f0ce6ad9dd8b980256b5f003fa814/faf4ee50c1d68e2b80257634003e38bf?OpenDocument&Highlight=0,administradores,deveres,de,cuidado,deveres,de,lealdade> accessed 17 February 2012 (this action did not directly concern a breach of duties, but the competence of the Commercial Court to decide on such matters). See also A. Menezes Cordeiro, 'Os deveres fundamentais dos administradores das sociedades', in: Revista da Ordem dos Advogados (2006), II <http://www.oa.pt/Conteudos/Artigos/detalhe_artigo.aspx?idc=30777&idsc=50879&ida=50925> accessed 17 February 2012.

[23] Pedro Caetano Nunes, *Dever de Gestão dos Administradores de Sociedades Anónimas* (Almedina, Coimbra, 2012); António Menezes Cordeiro, *Código das Sociedades Comerciais Anotado* (Almedina, 2007) 244.

3.2 To whom are the duties owed?

In order to comply with their duties, the law requires directors to act in the interests of the company, considering "the long term interests of the shareholders and taking into account the interests of other stakeholders relevant for the sustainability of the company, such as its employees, clients and creditors" (Code of Commercial Companies, Article 64(1)(b)). This provision seems to suggest that the different interests have to be balanced and are accorded equal weight.[24] However, part of the legal literature has extensively argued that these interests should be put in a hierarchical order when the diligent and organised director evaluates the "interests of the company": the interests of shareholders should be given priority, adopting a long-term perspective; on a secondary level, the interests of the remaining stakeholders are to be considered.[25] This seems to be the understanding of the courts as well.[26]

Moreover, although the reference to the interests of the company, shareholders, employees, clients and creditors is contained in Article 64(1)(b), which concerns the duty of loyalty, part of the literature argues that this is nonsensical. Indeed, the duty of loyalty is an absolute duty owed by the directors to the company. It is argued that it is not permissible to introduce a graduated understanding according to different interests. Thus, when interpreting the paragraph, the reference to stakeholder interests should be related to the duty of care, instead of the duty of loyalty.[27]

Directors who belong to corporate bodies performing audit functions, e.g., the "auditing committee" (Code of Commercial Companies, Article 423-B), must act in the interest of the company (Code Commercial Companies, Article 64(2)). This is justified by the need to ensure independence.

In the case of legal groups organised on the basis of a subordination agreement or complete domination (100% shareholdings), the directors of the parent company shall adopt, in relation to the group, the same diligence as legally required in the management of their individual company (Code of Commercial Companies, Article 504(1)). Directors of the parent company have the duty to act in the interest of the group (this results from the combination of Articles 504(1), 64, and 503(2) of the Code of Commercial Companies). The content of the duties will vary according to the particularities of each group, namely the degree of centralisation of the group's management and the autonomy granted by the group headquarters to subsidiary managers.[28]

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[24] This is the opinion of some commentators: António Menezes Cordeiro, *Código das Sociedades Comerciais Anotado* (Almedina, 2007) 244; Manuel Carneiro da Frada, 'A business judgement rule no quadro dos deveres gerais dos administradores', in: Revista da Ordem dos Advogados (2007), I <http://www.oa.pt/Conteudos/Artigos/detalhe_artigo.aspx?idc=30777&idsc=59032&ida=59045> accessed 17 February 2012.

[25] Jorge Manuel Coutinho de Abreu, 'Deveres de cuidado e de lealdade dos administradores e interesse social' in *Reforma do Código das Sociedades* (no. 3, Instituto de Direito das Empresas e do Trabalho, Almedina, 2007) 37 to 46; Paulo Câmara, 'O governo das sociedades e os deveres fiduciários dos administradores' in *Jornadas – Sociedades Abertas, Valores Mobiliários e Intermediação Financeira*'(Almedina, 2007) 173 to 176; Ricardo Costa/Gabriela Figueiredo Dias, *Código das Sociedades Comerciais em Comentário* (volume I, Almedina, 2010) 44 to 745.

[26] Adopted, for instance, by the Court of Appeal of Lisbon, in the action no. 26108/09.9T2SNT-A.L1-2, of 13 January 2011: <http://www.dgsi.pt/jtrl.nsf/33182fc732316039802565fa00497eec/5baa5ab5dcebba1f8025781d005b7e66?OpenDocument&Highlight=0,dever,de,dilig%C3%AAncia,dever,de,lealdade,administrador> accessed 17 February 2012).

[27] António Menezes Cordeiro, 'A lealdade no direito das sociedades', Revista da Ordem dos Advogados (2006), III <http://www.oa.pt/Conteudos/Artigos/detalhe_artigo.aspx?idc=30777&idsc=54103&ida=54129> accessed 17 February 2012; Manuel Carneiro da Frada, 'A business judgement rule no quadro dos deveres gerais dos administradores', Revista da Ordem dos Advogados (2007), I <http://www.oa.pt/Conteudos/Artigos/detalhe_artigo.aspx?idc=30777&idsc=59032&ida=59045> accessed 17 February 2012.

[28] See José Antunes, *The Law of Corporate Groups in Portugal.* Institute for Law and Finance, University of Frankfurt, Working Paper Series nº 84, 2008.

3.3 The director as a shareholder

The duties are only applicable when the director acts in his capacity as director of the company. When a shareholder who is simultaneously director of the company acts as shareholder, he is not subject to the duties of directors. According to some commentators, shareholders have to some extent duties similar to directors' duties, such as the duty of loyalty,[29] but such duties are inherent in the position of shareholder and do not derive from the fact that the shareholder also holds the office of director. However, parts of the legal literature[30] and case law[31] argue that a shareholder who is simultaneously a director has advantages in comparison to the other shareholders and, thus, he is under a more stringent duty to respect the company's interests and it is more objectionable when he does not consider these interests.

3.4 The time span of the duties

Directors' duties begin when the director accepts, expressly or implicitly, the appointment by the general meeting to hold the office (Code of Commercial Companies, Article 391(1) and (5)). As to *de facto* or shadow directors, the duties begin when they start performing, directly or indirectly, and in an autonomous way functions usually performed by *de iure* directors.

The duties end when the director is no longer director of the company, namely because he was dismissed (Code of Commercial Companies, Article 403) or resigned from office (Code of Commercial Companies, Article 404). The dismissal produces effects from the date of the general meeting's decision; the resignation takes effect at the end of the month following the month when it was communicated to the company (except if a new director is elected). Regarding *de facto* or shadow directors, the duties end when they stop performing management functions.

[29] For instance, a decision of the general shareholders' meeting which intends to convey special advantages on a shareholder or third parties is voidable. The decision will only be valid if it is proven that it would have been taken without the votes of the interested shareholder (Code of Commercial Companies, Article 58(1)(b)).
[30] Pedro Pais Vasconcelos, *A Participação Social nas Sociedades Comerciais* (2nd Edition, Almedina, 2006) 366.
[31] This was the understanding of the Supreme Court of Justice in the action no. 242/09.3YRLSB.S1, of 31 March 2011: <http://www.dgsi.pt/jstj.nsf/954f0ce6ad9dd8b980256b5f003fa814/064c889357cb52b080257865003530c6?OpenDocument&Highlight=0,administradores,deveres,de,cuidado,deveres,de,lealdade> accessed 17 February 2012.

4 LIABILITY FOR BREACH OF DUTY

4.1 Duty of care: conditions for liability

When performing their functions, directors have to act according to a general duty of care (Code of Commercial Companies, Article 64(1)(a)). The standard of care is objective. The directors must employ the care of an orderly and diligent manager. The Code of Commercial Companies contains some guidance and refers to the elements that should be taken into consideration when the director's conduct is assessed, namely the "willingness", the "technical competence" and the "knowledge of the company's business" appropriate in light of the functions that the director performs. According to the case law, directors must "employ, when taking management decisions and exercising corporate control, the time, effort and knowledge required by the nature of the functions, their specific competences and the circumstances".[32] In determining the content of the duty of care, other circumstances should be taken into consideration to analyse the concrete behaviour of the director: the type, object and size of the company, the economic sector where the company is active, the nature and importance of the decision taken (day-to-day management or extraordinary decision), the time available to obtain information and take the decision, and the type of behaviour usually adopted under such circumstances.[33] As argued by the Supreme Court of Justice, "this is an objective standard, which is not the bonus pater familias, but a manager with certain capacities . . . From the objective nature of the standard of care results the indifference to the personal circumstances of the director, namely his incapacity or incompetence to manage companies" .[34]

The objective standard described above is mitigated by a special legal provision introduced by the reform of 2006, which is inspired by the US-American *business judgment rule*. If the director proves that he acted in an informed way, free of any personal conflicts and according to the criterion of entrepreneurial rationality, he is presumed to have complied with his duties and his liability is excluded (Code of Commercial Companies, Article 72(2)). The specific content of the duty to prepare the decision adequately and obtain the relevant information will vary according to the circumstances in which the decision is taken (for instance, the importance of the decision, the time available and the costs of the information).[35] As to entrepreneurial rationality, considering the reasons for the adoption of the Portuguese business judgement rule and the intent to facilitate the proof of rationality, this requirement needs to be interpreted restrictively. The director has to show that his decision was not irrational, meaning that he took a reasonable and adequate decision compared with the set of decisions that could have been taken by a diligent and organised manager.[36] More specifically, a reasonable decision requires directors not to dissipate the company's assets and not to take

[32] Decision of the Court of Appeal of Porto in the action no. 5545/08, 3rd Section, of 05.02.2009: <http://www.trp.pt/jurisprudenciacivel/civel08_5545.html> accessed 17 February 2012.
[33] Ricardo Costa/Gabriela Figueiredo Dias, *Código das Sociedades Comerciais em Comentário*' (volume I, Almedina, 2010) 731 to 732.
[34] Decision under the action no. 09A0346, of 28.04.2009: <http://www.dgsi.pt/jstj.nsf/954f0ce6ad9dd8b980256b5f003fa814/adce8aedd2c212ff802575cc003022fd?OpenDocument> accessed 17 February 2012.
[35] Jorge Manuel Coutinho de Abreu, *Responsabilidade civil de administradores de sociedades* (no. 5, 2nd Edition, Instituto de Direito das Empresas e do Trabalho, Almedina, 2007) 21.
[36] Jorge Manuel Coutinho de Abreu, *Responsabilidade civil de administradores de sociedades* (no. 5, 2nd Edition, Instituto de Direito das Empresas e do Trabalho, Almedina, 2007) 23; and Bruno Ferreira, 'Os deveres de cuidado dos administradores e gerentes: análise dos deveres de cuidado em Portugal e nos Estados Unidos da América fora das situações de disputa sobre o controlo societário' in Revista de Direito das Sociedades (no. 3, Almedina, 2009) 729 to 730.

disproportionate risks. The standard of rationality is objective and, thus, the personal belief of the director in the correctness of the decision is irrelevant.[37]

The standard of care may vary according to the functions performed by the directors in the different corporate governance models available.[38] In the so-called *classic or Latin model* all of the directors on the board ("Conselho de Administração") are competent to make business decisions, although it is possible to attribute certain functions to specific members (when the articles of association do not prohibit this). Thus, the same standard of care applies and the directors are jointly and severally liable for a breach of duty. However, they enjoy a right to recourse according to the proportion of their fault and its consequences (Code of Commercial Companies, Article 73). The internal division of powers by delegation (Code of Commercial Companies, Article 407(1) and (2)) may have an impact on the internal relationships between the directors, i.e. the right to recourse.

Moreover, directors may be authorised to delegate certain matters of the day-to-day management of the company to one or more directors or to an executive committee (Code of Commercial Companies, Article 407(3) and (7)).[39] In this case, the board continues to have the competence to decide on the delegated matters. It is subject to oversight liability with respect to the activities of the director to whom responsibilities have been delegated or the members of the executive committee (Code of Commercial Companies, Article 407(8)). If the non-executive directors are aware of any prejudicial acts or omissions or of any intention of the executive directors to engage in conduct that may amount to a breach of duty, they must make enquiries and ask the board to intervene (Code of Commercial Companies, Article 407(8)). Thus, the standard of care of non-executive directors in the case of delegation is lower than the standard applicable to executive directors, as they are only bound by a duty to monitor the performance of the executive directors and make enquiries. This duty does not mean that directors cannot rely on the accuracy of the information provided. However, they have to examine critically the information received from other directors, employees and other parties and act when there are evident mistakes or signs of incorrect behaviour. An example of the duty to be informed is the following: The chairman of the executive committee has to ensure that all the information is provided to the other members of the board in relation to the committee's activities and decisions (Code of Commercial Companies, Article 407(6)(a)). With regard to non-delegated matters, the non-executive directors have to comply with the ordinary standard of care and are jointly and severally liable for any breach.[40]

In the so called one-tier or *Anglo-Saxon model*, the members of the executive board of directors ("Conselho de Administração Executivo") are bound by the ordinary standard of care (the same that is applicable to members of the board of directors in the classic model). On the other hand, non-executive directors of the audit committee perform functions similar to the ones performed by the audit board in the classic model: generally speaking, these directors are in charge of carefully monitoring the performance of the executive directors in managing the company, the compliance with provisions of law and the articles of association, the accuracy and regularity of the company's books and records, and the accounting policies and valuing criteria adopted by the company (Code of Commercial

[37] Jorge Manuel Coutinho de Abreu, *Responsabilidade civil de administradores de sociedades* (no. 5, 2nd Edition, Instituto de Direito das Empresas e do Trabalho, Almedina, 2007) 23.
[38] See above 1.3.
[39] Alexandre Soveral Martins, *Comissão Executiva, Comissão de Auditoria e Outras Comissões na Administração,* in: AAVV, "Reformas do Código das Sociedades", 243-275 (Almedina, Coimbra, 2007).
[40] João Calvão da Silva, 'Responsabilidade civil dos administradores não executivos, da Comissão de Auditoria e do Conselho Geral e de Supervisão', Revista da Ordem dos Advogados <http://www.oa.pt/Conteudos/Artigos/detalhe_artigo.aspx?idc=30777&idsc=59032&ida=59049> accessed 17 February 2012.

Companies, Article 423-F). As they perform auditing functions, they are also subject to the duty of care, but with a higher standard of care: they must employ high standards of professional diligence in the interest of the company (Code of Commercial Companies, Article 64(2)).[41] Analytic and specific monitoring is demanded.[42]

Pursuant to Article 81 of the Code of Commercial Companies, the members of the audit committee are liable according to the same terms applicable to the directors who perform management functions. Thus, it is discussed in the legal literature whether such members might benefit from the Portuguese business judgement rule (which, as we saw, is provided for in the sections of the Code of Commercial Companies dealing with the liability of directors or members of the management organ). According to the proposal of the Portuguese CMVM, which strongly influenced the reform of 2006 regarding corporate governance issues, the Portuguese business judgment rule was not applicable to the members of the audit committee.[43] However, some commentators argue that it may be applicable, depending on the nature of the functions performed. If the decision implies a discretionary margin, the members of the audit committee benefit from the Portuguese business judgment rule; if no discretion or power of decision exists, the rule is not available.[44]

The audit committee's members are jointly and severally liable for the acts performed by the delegated directors or the members of the executive committee when the losses would not have arisen if they had duly discharged their audit functions (Code of Commercial Companies, Article 81(2)). If the audit committee's chairman does not communicate facts to the chairman of the board of directors that he knows or should know and that reveal serious difficulties in the attainment of the company's objects – namely non-payment to creditors, tax or social security authorities – he is jointly and severally liable with the members of the board of directors for the losses caused to the company (Code of Commercial Companies, Article 420-A(1) to (5)). The remaining non-executive directors – who do not belong to the audit committee – continue to be subject to the duty to monitor the performance of the delegated directors and make enquiries according to the standard described in the previous paragraphs.

Finally, in the so-called two-tier or *German model*, the members of the executive board of directors ("Conselho de Administração Executivo") are bound by the ordinary standard of care (the same that is applicable to members of the board of directors in the classic model and the executive board of directors in the Anglo-Saxon model). The standard applicable to the members of the general and supervisory board ("Conselho Geral e de Supervisão") corresponds to that of the audit committee's members in the Anglo-Saxon model (here, again, it is discussed whether the Portuguese business judgment rule should apply). However, in relation to matters which, under the law or the articles of association, belong to the executive board but require the prior consent of the general and supervisory board (Code of Commercial Companies, Article 442), the ordinary standard of care is applicable to the members of the general and supervisory board.[45] Even if the board establishes committees for the

[41] There seems to exist no case law on these issues, probably due to the rare use of the Anglo-Saxon model (only some of the listed companies adopt it).
[42] João Calvão da Silva, 'Responsabilidade civil dos administradores não executivos, da Comissão de Auditoria e do Conselho Geral e de Supervisão', Revista da Ordem dos Advogados <http://www.oa.pt/Conteudos/Artigos/detalhe_artigo.aspx?idc=30777&idsc=59032&ida=59049> accessed 17 February 2012.
[43] Proposal issued on January 2006: <http://www.cmvm.pt/CMVM/Comunicados/Comunicados/Documents/56be6a08403749cbbfdada63db3da0aaproposta_alter_csc.pdf> accessed 17 February 2012.
[44] Gabriela Figueiredo Dias, *Código das Sociedades Comerciais em Comentário* (volume I, Almedina, 2010) 940.
[45] João Calvão da Silva, 'Responsabilidade civil dos administradores não executivos, da Comissão de Auditoria e do Conselho Geral e de Supervisão', Revista da Orde dos Advogados <http://www.oa.pt/Conteudos/Artigos/detalhe_artigo.aspx?idc=30777&idsc=59032&ida=59049> accessed 17 February 2012.

execution of specific powers (Code of Commercial Companies, Article 444), the standard of care will be the same because there is no delegation, just a factual division of powers.[46]

For the sake of understanding how the duty of care is applied by the Portuguese courts, it is worth giving some case law examples:

(i) The Supreme Court of Justice, in case nº 09A0346 of 28 April 2009, decided that the directors breached their duty of care by depositing the amount of an indemnity, which the company was judicially condemned to pay to a shareholder, in a bank account jointly owned by the shareholder and her husband. The Court concluded that the directors did not act as diligent and organised managers because they did not inquire how they should proceed with the payment, including the required safety, did not notify the shareholder of the payment and did not ask for the shareholder's instructions as to the best way to proceed with the payment.[47]

(ii) The Court of Appeal of Lisbon, in case nº 6083/09.0TVLSB.L1-6 of 16 June 2011, held that a director breached the duty of care because he had falsified the minutes of two board meetings and informed the media, without the consent of the other directors, of the existence of a contract which was protected by a confidentiality clause. The director did not meet the behavioural standards of a diligent and organised manager.[48] (iii) Finally, the Court of Appeal of Évora, in case nº 1706/05.3TBLLE.E1 of 17 March 2010, decided in favour of a breach of the duty of care because the directors decided to discontinue the operation of the company's restaurant, the only asset owned by the company, which allowed it to operate. With no business activity, the company became insolvent.[49]

4.2 Duty of loyalty: conditions for liability

As a direct consequence of the fiduciary relationship between the company and the directors, directors are bound by a duty of loyalty (Code of Commercial Companies, Article 64(1)(b)). Directors shall act exclusively in the company's interests, refraining from promoting their own benefit or outside interests.[50]

The duty of loyalty is reflected in the following sub-duties: The director is required (i) not to enter, directly or by means of a nominee, into certain contracts or agreements with the company (Code of Commercial Companies, Articles 397(2) and 428); (ii) not to perform any activity competing with the company without the previous consent of the general shareholders' meeting (Code of Commercial Companies, Articles 398(3) and 428); (iii) not to vote in decisions of the board of directors on matters

[46] The delegation of powers allowed in the classic and Anglo-Saxon models is not legally foreseen in the German model (Code of Commercial Companies, Article 431(3)).
[47] See: <http://www.dgsi.pt/jstj.nsf/954f0ce6ad9dd8b980256b5f003fa814/adce8aedd2c212ff802575cc003022fd?OpenDocument> accessed 17 February 2012.
[48]See: <http://www.dgsi.pt/jtrl.nsf/33182fc732316039802565fa00497eec/d5e8eff5e79c2eb0802578e800392ab2?OpenDocument&Highlight=0,dever,de,dilig%C3%AAncia,dever,de,lealdade,administrador> accessed 17 February 2012.
[49]See: <http://www.dgsi.pt/jtre.nsf/c3fb530030ea1c61802568d9005cd5bb/7bbc1c6ca715c80e8025788c0051509d?OpenDocument&Highlight=0,responsabilidade,deveres,administrador> accessed 17 February 2012.
[50] This was the understanding of the Court of Appeal of Porto in the above mentioned case nº 5545/08 of 05.02.2009 <http://www.trp.pt/jurisprudenciacivel/civel08_5545.html> accessed 17 February 2012.

in which the director has, directly or through a third party, a conflict of interests with the company (Code of Commercial Companies, Article 410(6)); (iv) not to abuse "non-public" information of the company (Code of Commercial Companies, Articles 449 and 450, referring to the use of information which might influence the value of the company's shares, i.e. insider trading); and (v) in case of a take-over, directors of the target company shall not perform acts that may significantly affect the objectives announced by the offeror, apart from the normal day-to-day management of the company (Code of Securities, Article 182(1)).

Other sub-duties, although not expressly mentioned in the Code of Commercial Companies, are recognised by the courts[51] and the legal literature.[52] Directors are prohibited from (i) enjoying advantages of third parties related to the execution of contracts between the company and such third parties; (ii) taking advantage of business opportunities that belong to the company, to the benefit of the director or a third party, without the company's consent;[53] (iii) using means or information of the company to their own benefit, without any advantage for the company; and (iv) revealing confidential information and documents of the company.

The more important sub-duties require a more detailed analysis. First, the Code of Commercial Companies contains several rules on self-dealing, i.e. transactions between the directors and the company. On the one hand, the company is prohibited from entering into loan or other credit agreements with directors, making payments on behalf of directors, providing guarantees regarding the directors' obligations or paying in advance remuneration corresponding to more than one month (Code of Commercial Companies, Article 397(1)). On the other hand, any agreement entered into between the company and its directors, directly or through a third party, has to be approved by the board of directors – with the interested director abstaining from voting – and receive a favorable opinion of the audit board (Code of Commercial Companies, Article 397(2)). Such formalities are not required when the agreement or act is part of the company's normal activities and no special advantage accrues to the interested director (Code of Commercial Companies, Article 397(5)).[54] These legal rules also apply to agreements entered into with companies which are in a domination or group relationship with the director's company (Code of Commercial Companies, Article 397(3)). Non-compliance with the rules leads to the invalidity of the agreement (Code of Commercial Companies, Article 397(2)).

The following decision of the Court of Appeal of Porto is an example of the interpretation of this sub-duty: The director of a company sold an immovable asset to another company in which he was a shareholder. The plaintiffs argued that the director breached his duties because, among other

[51] The Supreme Court of Justice stated that the duty of loyalty is usually associated with "the obligation not to compete, the obligation not to use potential business opportunities to his [the director's] benefit, and not to act in conflicts of interest" (case nº 242/09.3YRLSB.S1, of 31 March 2011 <http://www.dgsi.pt/jstj.nsf/954f0ce6ad9dd8b980256b5f003fa814/064c889357cb52b080257865003530c6?OpenDocument&Highlight=0,administradores,deveres,de,cuidado,deveres,de,lealdade> accessed 17 February 2012).

[52] António Menezes Cordeiro, 'A lealdade no direito das sociedades', Revista da Ordem dos Advogados (2006), III <http://www.oa.pt/Conteudos/Artigos/detalhe_artigo.aspx?idc=30777&idsc=54103&ida=54129> accessed 17 February 2012; Manuel Carneiro da Frada, 'A business judgement rule no quadro dos deveres gerais dos administradores', Revista da Ordem dos Advogados (2007), I <http://www.oa.pt/Conteudos/Artigos/detalhe_artigo.aspx?idc=30777&idsc=59032&ida=59045> accessed 17 February 2012; Ricardo Costa/Gabrielea Figueiredo Dias, *Código das Sociedades Comerciais em Comentário*, volume I (Almedina, 2010) 726 to 727.

[53] According to some Portuguese doctrine, this general prohibition of using corporate opportunities is also applicable to directors who have resigned from office precisely for the purpose of exploiting the certain corporate opportunity (José Manuel Coutinho de Abreu, *Responsabilidade Civil dos Administradores de Sociedades,* 33 (Almedina, Coimbra, 2007)).

[54] Special advantages are those which do not correspond to the normal advantages in the legitimate course of business and increase the director's assets to the detriment of the company, see António Menezes Cordeiro, *Código das Sociedades Comerciais Anotado* (Almedina, 2007) 975.

reasons, he promoted his own interests and caused a loss to the company. The court decided that there was no breach of the duty of loyalty because the plaintiffs did not prove that the market price of the asset was different than the transaction price, and the value of the asset was entirely received by the company.[55]

Second, directors cannot perform, on their own account[56] or the account of others,[57] an activity competing with the company, perform functions in a competitor company or be appointed for or in representation of the later (Code of Commercial Companies, Articles 398(3) and 428). A competing activity is any activity that falls within the corporate object of the company, provided that it is performed by the company or its performance was decided by the shareholders (Code of Commercial Companies, Articles 398(5) and 254(2)). *De facto* activities performed by the company are also included; isolated competing acts of the directors are not considered to amount to a "competing activity", provided that they do not constitute the use of corporate opportunities.[58] The prohibition does not apply if the shareholders (Code of Commercial Companies, Articles 398(5) and 254(1)) or the general and supervisory board (Code of Commercial Companies, Article 428) give their consent. An example of a breach of this sub-duty of loyalty was analysed by the Court of Appeal of Lisbon: The company brought an action against a former director because he had set up a competing enterprise with facilities next to the first company while holding office. He did so by using information regarding clients, prices and employees obtained during the performance of his duties. The court held that the director was liable because of the unlawful use of information received when he was a director in favor of the new company incorporated by him.[59]

Finally, a director breaches his duty of loyalty if he makes use of a corporate opportunity without the consent of the shareholders or the general and supervisory board (Code of Commercial Companies, Articles 254, 398(3) and 428 are applicable by analogy). An opportunity belongs to the company if it falls within its scope of activity, the company has an objectively relevant interest in the opportunity, or it has expressed its interest in the opportunity and received a contractual proposal or is in negotiations.[60] This prohibition applies to the opportunities of which the director becomes aware while performing his functions or when he is contacted due to his role in the company. Opportunities offered to the director in his personal capacity are excluded.[61]

[55] Decision in case nº 0835545, of 5 February 2009: <http://www.dgsi.pt/jtrp.nsf/c3fb530030ea1c61802568d9005cd5bb/6e04ab3653f8b18f8025757d0053dd04?OpenDocument&Highlight=0,dever,de,cuidado,dever,de,lealdade,administrador> accessed 17 February 2012.
[56] This includes the direct or indirect ownership in a company in which the director has unlimited liability, as well as the ownership of at least 20% of the share capital or the profits of a company with limited liability (Code of Commercial Companies, Article 254(3)).
[57] In his own name or as a representative of the third party.
[58] Jorge Manuel Coutinho de Abreu, *Deveres de cuidado e de lealdade dos admnistradores e interesse social*' in '*Reformas do Código das Sociedades* (no. 3, Instituto de Direito das Empresas e do Trabalho, Almedina, 2007) 25.
[59] Decision in case nº 242/2009-7 of 12 May 2009: <http://www.dgsi.pt/jtrl.nsf/33182fc732316039802565fa00497eec/154db299c4295ed8802575c90038469c?OpenDocument&Highlight=0,administradores,deveres,de,cuidado,deveres,de,lealdade,responsabilidade> accessed 17 February 2012. The Supreme Court of Justice confirmed this decision in case nº 242/09.3YRLSB.S1 of 31 March 2011: <http://www.dgsi.pt/jstj.nsf/954f0ce6ad9dd8b980256b5f003fa814/064c889357cb52b080257865003530c6?OpenDocument&Highlight=0,administradores,deveres,de,cuidado,deveres,de,lealdade> accessed 17 February 2012).
[60] Jorge Manuel Coutinho de Abreu, '*Deveres de cuidado e de lealdade dos admnistradores e interesse social*' in '*Reformas do Código das Sociedades*' (no. 3, Instituto de Direito das Empresas e do Trabalho, Almedina, 2007) 26 to 27.
[61] Jorge Manuel Coutinho de Abreu, '*Deveres de cuidado e de lealdade dos admnistradores e interesse social*' in '*Reformas do Código das Sociedades*' (no. 3, Instituto de Direito das Empresas e do Trabalho, Almedina, 2007) 27.

4.3 Specificities of groups

In the case of legal groups organised on the basis of a subordination agreement or a 100% shareholding, the directors of the parent company must perform their duties taking into account the interest of group as a whole; therefore, they may be held liable before group subsidiaries under the same terms as in relation to their own parent company (Code of Commercial Companies, Article 504). The directors of the subsidiary company are not liable when they act in accordance with the lawful instructions received from the parent company (Code of Commercial Companies, Article 504(3)).

4.4 General conditions for liability

In general terms, directors face three different types of liability: directors may be held liable towards the company (Code of Commercial Companies, Article 72), creditors (Code of Commercial Companies, Article 78), and individual shareholders or even third parties (Code of Commercial Companies, Article 79). Whereas directors' liability towards the company is based on a direct loss suffered by the company, the liability towards creditors is based on the indirect loss suffered by the creditors of the company (in consequence of an insufficiency of the company's assets caused by a violation of legal rules aiming to protect the assets), and liability towards individual shareholders or third parties is based on a direct loss caused by the directors to them (e.g., refusal to pay a dividend lawfully approved by the general meeting).[62]

The central piece of this system of liability is the directors' liability towards the company. The liability of directors depends on the general requirements provided for by civil law, that is, an unlawful act or omission, fault, loss, and a causal link between the act or omission and the loss. First, there has to be an unlawful breach of duties due to an intentional or negligent act or omission by the director when performing his functions (assessed according to the criteria discussed above). The second condition is that the company has suffered a loss. Finally, directors are only liable if there is a casual link between the act or omission on which the liability is based and the loss suffered by the company. In this regard, the Code of Commercial Companies contains no specific provisions and the general regime of the Civil Code applies. Portuguese law has adopted the theory of adequate causation (Civil Code, Article 563). This requires a two-step analysis: First, the act has to be a necessary condition of the loss (*condition sine qua non*); second, the causal relationship needs to be adequate, which means that the act, according to the ordinary course of events and experience, was likely to produce an effect of the kind which occurred. In the case of liability to creditors, the causation is double because it requires the loss to be caused by the insufficiency of the company's assets and this to be caused by the breach of duties.

4.5 Who bears the burden of proof

The plaintiff has to prove the unlawful breach of duty, the existence of a loss and loss causation. As regards fault (intention or negligence), Portuguese law contains an express presumption of the director's fault (Code of Commercial Companies, Article 72(1)). Thus, the burden of proof is on the director. Nevertheless, in application of the Portuguese business judgement rule, it is sufficient for the

[62] See also below 6.1.2.1. and 6.1.3.

director to show that he acted in an informed way, free of any personal conflicts and according to entrepreneurial rationality in order to rebut the presumption (Code of Commercial Companies, Article 72(2)).[63] In such a case, the court will not review the director's decision. While some authors argue that the Portuguese business judgment rule is applicable to both the duty of care and the duty of loyalty,[64] the majority of the literature understands the business judgement rule as not applying to the duty of loyalty because here directors do not enjoy discretion when making decisions.[65] In the case law regarding the duty of loyalty, no reference is made to the Portuguese business judgement rule.

4.6 Exemptions and limitations

Under the Code of Commercial Companies, any clause, provided for or not in the articles of association, which excludes or limits the liability of directors or which states that the right of the shareholders to bring an action on behalf of the company depends on a previous judicial decision about the existence of the cause of action or dismissal of the director, is void (Code of Commercial Companies, Article 74). However, some authors adopt a restrictive interpretation of this prohibition, arguing that it is possible to exclude directors' liability in the case of negligence. Under this view, only gross negligence could not be excluded.[66]

In principle, the general prohibition of provisions exempting or limiting the directors' liability also extends to any indemnity arrangements, i.e. provisions of the articles of association by which, directly or indirectly, the company assumes the financial costs of the liability of its own directors.

However, the company may renounce its right to damages after the facts that give rise to the director's liability have occurred. For such a waiver, an express resolution of the shareholders is necessary that is approved by the majority, without minority shareholders representing at least 10% of the share capital voting against the resolution (the potentially liable person has to abstain from voting) (Code of Commercial Companies, Article 74(2)). If these requirements are not complied with or the waiver is adopted *ex ante*, it is not effective in relation to the company. During insolvency proceedings, the company has no power to waive its rights.

Moreover, there are other circumstances which may lead to the exclusion of liability. First, directors are not liable to the company when the losses arise from a decision of the management body and they did not participate in that decision because they were neither present nor represented or, although present, they were prevented from voting or were outvoted. An express vote against the decision of the majority is required (Code of Commercial Companies, Article 72(3)). However, the director who did not participate in the decision may be liable if he did not use the right to oppose the decision when he

[63] The majority of the legal literature argues that the business judgment rule cannot be used by directors in actions brought by the creditors, shareholders, or third parties in their own capacity (see Section 5), because the law requires the breach of specific rules which protect those constituencies (there is no discretion; the question is simply one of compliance or non-compliance). See, e.g., Jorge Coutinho de Abreu/Maria Elisabete Ramos, *Código das Sociedades Comerciais em Comentário* (volume I, Almedina, 2010) 898 and 912.

[64] Adelaide Menezes Leitão, 'Responsabilidade dos Administradores para com a Sociedade e os Credores Sociais por violação de normas de protecção', in Revista de Direito das Sociedades (no. 3, Almeina, 2009) 670.

[65] António Menezes Cordeiro, 'A lealdade no direito das sociedades', Revista da Ordem dos Advogados (2006), III <http://www.oa.pt/Conteudos/Artigos/detalhe_artigo.aspx?idc=30777&idsc=54103&ida=54129> accessed 17 February 2012; Ricardo Costa/Gabrielea Figueiredo Dias, *Código das Sociedades Comerciais em Comentário* (volume I, Almedina, 2010) 747 to 748.

[66] As pointed out by João Calvão da Silva, 'Responsabilidade civil dos administradores não executivos, da Comissão de Auditoria e do Conselho Geral e de Supervisão', Revista da Ordem dos Advogados <http://www.oa.pt/Conteudos/Artigos/detalhe_artigo.aspx?idc=30777&idsc=59032&ida=59049> accessed 17 February 2012.

was able to do so. For instance, if a decision is void the director shall not execute it or let it be executed (Code of Commercial Companies, Article 72(4)).

Finally, there will be no liability towards the company if the act is based on a decision of the shareholders, even a voidable one (Code of Commercial Companies, Article 72(5)). However, according to the legal literature, this provision has to be interpreted restrictively. For example, upon the occurrence of new events which materially change the circumstances under which the decision was taken or if the decision was based on false information provided by directors, the directors may be found liable. As to voidable resolutions, if the directors understand that the resolution will probably be voided and that the potential loss of carrying out the resolution is relevant, they may be liable if they nevertheless execute it.[67]

4.7 Insurance against liability

In stock corporations, directors are required to provide for security against their liability by arranging for a guarantee or taking out an insurance policy and appointing as beneficiary any person entitled to compensation (Code of Commercial Companies, Article 396). The amount to be guaranteed has to be fixed by the shareholders in the articles of association, but, as a general rule, shall not be less than € 50,000, or € 250,000 for companies issuing securities admitted to trading on a regulated market and large companies.[68]

The general meeting of shareholders or the general and supervisory board may waive the right to require a guarantee, except for companies listed on a regulated market and large companies (Code of Commercial Companies, Article 396(3)). In practice, in spite of the low minimum amount required, most companies opt for waiving this right. In the rare cases where there is no waiver, the guarantee (or the insurance) has to be provided within 30 days from the election and remain valid until the end of the calendar year subsequent to that in which the director leaves office (Code of Commercial Companies, Article 396(4)). The costs of the insurance (or guarantee) have to be borne by the director, but the company may pay the amount which exceeds the above mentioned minimum coverage (Code of Commercial Companies, Article 396(2)).

The above mentioned insurance does not correspond entirely to the professional insurance of directors (D&O Insurance). However, the use of D&O Insurance is now quite common in Portugal and allows widening the types of loss covered by the mandatory guarantee. A number of different situations are covered: expenses and claims, condemnations or judicial agreements not indemnified by the company (side A coverage); indemnification paid by the company to the directors (side B coverage); or liability of the company itself (side C coverage).[69] Usually, the insurance policies contain some limitations of the coverage in situations such as: losses arising due to an unlawful advantage, gain, benefit, profit or remuneration obtained by the director; fines due as punitive damages; exemplary damages; claims arising from willful misconduct of directors; and insured vs. insured exclusions.[70]

[67] Jorge Manuel Coutinho de Abreu, *Responsabilidade civil de administradores e de sócios controladores* (no. 3, Instituto de Direito das Empresas e do Trabalho, Almedina, 2004).
[68] See note 12 above.
[69] António Menezes Cordeiro, *Código das Sociedades Comerciais Anotado* (Almedina, 2007) 973.
[70] Pedro Pais Vasconcelos, *D&O Insurance: O Seguro de Responsabilidade Civil dos Administradores e outros Dirigentes da Sociedade Anónima,* in: "Estudos em Homenagem ao Prof. Doutor I. Galvão Telles", 1154-1182, Almedina, Coimbra, 2007.

4.8 Consequences of liability

As we have seen, the director who breaches his duties might be liable and be asked to pay damages for the loss suffered. Moreover, in case of serious breach, the company might dismiss him with just cause (Code of Commercial Companies, Article 403(4)). Finally, if the duty was breached through a resolution of the board, such resolution is void (Code of Commercial Companies, Article 411(1)(c)).

5 Duties in the vicinity of insolvency

In Portugal, there is no explicit shift of directors' duties in the vicinity of insolvency; indeed, the concept of "vicinity of insolvency" is not expressly acknowledged by the law or the courts. However, this does not mean that directors' duties are not influenced by the vicinity of insolvency. First of all, as described above,[71] when defining the beneficiaries of directors' duties, the law considers that the duties do not only aim at promoting the interests of shareholders, but that the interests of other stakeholders have to be taken into consideration as well, among which the law expressly mentions the interests of creditors. Therefore, one may say that creditors' interests are already one of the dimensions protected by directors' duties, both with regard to solvent companies and companies in the vicinity of insolvency. Secondly, the Portuguese legislator is not indifferent to the possible externalities that creditors may face when a company is in financial distress. This problem is addressed by the creation of specific duties and liability which aim at ensuring that the company ceases to trade when a continuation of the business activities would unduly affect creditors. Thus, creditors receive a greater protection in the vicinity of insolvency.

On the one hand, there is a specific duty of directors in the case of loss of half of the share capital. Under Article 35 of the Code of Commercial Companies, if the accounts of the company show that half of the share capital is lost or there are reasonable grounds to believe that such loss might occur, the directors must immediately convene a general shareholders' meeting. In the notice convening the meeting the directors have to mention, at least, the following possible measures: winding-up the company, reduction of the share capital to an amount, at least, equal to the company's equity capital[72] and realisation of new contributions to increase the share capital. The non-compliance with this duty may lead to criminal liability of the directors if they act intentionally, punishable by fine or imprisonment (Code of Commercial Companies, Article 523).[73]

On the other hand, the director has the duty to start insolvency proceedings within 60 days from the date when he knows or should have known that the company is in an economic situation of insolvency (Code of Insolvency, Articles 18 and 19). The notion of insolvency varies according to the type of company. While a situation of insolvency is deemed to exist for all types of companies when the company is unable to meet its debts as they fall due (Code of Insolvency, Article 3(1)), stock corporations and limited liability companies may also be considered insolvent in the absence of cash-flow insolvency when their assets are clearly insufficient to cover their liabilities according to applicable accounting rules (Code of Insolvency, Article 3(2)).[74] Furthermore, the situation of imminent

[71] See above 3.1. and 3.2.
[72] In this case, the creditors who have asked the company to pay or guarantee the debts in the 15 days prior to the publication of the reduction of the share capital may, within 1 month from such publication, ask the court to prohibit or limit the distribution of reserves or dividends if the company does not pay or guarantee its debts. During the 15 day period or as soon as the company knows that the creditor submitted the request, the company cannot make such distributions (Code of Commercial Companies, Article 96).
[73] On the minimum ratio between the value of net assets of the company and the nominal value of its share capital, see Alexandre Mota Pinto, *O Artigo 35.º do Código das Sociedades Comerciais na Versão Mais Recente,* in: "Temas Societários", nº 2, 107-151, Almedina, Coimbra, 2006; see also the judgment of the Supreme Court of Justice of 5-VII-2001, in: IX "Coletânea de Jurisprudência" (2001), II, 170-172.
[74] Maria do Rosário Epifânio, *Manual de Direito da Insolvência,* 19 and ff. (4th edition, Almedina, Coimbra, 2012).

insolvency, where the company has started insolvency proceedings, is treated similar to actual insolvency (Code of Insolvency, Article 3(4)).[75]

Failure to apply for the opening of insolvency proceedings in a timely fashion may result in direct civil liability of the director for the damage arising from the delay,[76] as well as in criminal liability.[77] Moreover, in this case the Code of Insolvency, Article 186(3), sets forth a rebuttable presumption of the director's fault, which leads to the classification of the insolvency as culpable (and not fortuitous). This classification will lead to the application of specific sanctions, including the director's disqualification.

[75] Maria do Rosário Epifânio, *Manual de Direito da Insolvência,* 23 and ff. (4th edition, Almedina, Coimbra, 2012).
[76] Under the general terms applicable to tort liability (Civil Code, Article 483).
[77] Pursuant to the Criminal Code, Article 227, a director is criminally liable if he performs certain acts which damage or diminish the company's assets with the intention to prejudice creditors and the company's insolvency is found to be culpable.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue

6.1.1 The company as plaintiff

The liability of directors towards the company is enforced by the company, as plaintiff, through a corporate liability action (*ut universi*). Pursuant to the Code of Commercial Companies, Article 75(1), the decision to bring this action has to be approved by the shareholders' general meeting by simple majority and has to be brought within six months from the date of the decision. If any of the shareholders is the defendant director, he cannot vote in the general meeting (Code of Commercial Companies, Article 75(3)).

Considering the potential conflict of interest with the directors, the shareholders may appoint a special attorney to represent the company (Code of Commercial Companies, Article 75(1)). Moreover, the court, upon the request of shareholders representing at least 5% of the share capital, will appoint a special attorney to represent the company in the action if the shareholders did not make such appointment or it is necessary to replace the attorney appointed by the shareholders (Code of Commercial Companies, Article 76(1)). In this case, if the company's action is dismissed, the minority who asked for the appointment is liable to reimburse the company for the legal costs and other expenses incurred by such appointment (Code of Commercial Companies, Article 76(3)).

The company may waive an existing claim by an express resolution of the shareholders approved by the majority, without minority shareholders representing at least 10% of the share capital voting against the resolution. The potentially liable person has to abstain from voting, Code of Commercial Companies, Article 74(2). During insolvency proceedings, the company has no power to waive an existing claim.

6.1.2 The shareholders as plaintiffs

6.1.2.1 In their own name

Shareholders (in their own name) and third parties can bring an action against directors for the losses that they have suffered directly. The enforcement of the directors' duties will depend on the following specific conditions:

(1) The directors have breached rights or legal provisions which protect shareholders or third parties, e.g., the right to receive dividends that were approved by a lawful general meeting (Article 294 (2) of Code of Commercial Companies)).

(2) Losses were suffered directly by the shareholders or by third parties (Code of Commercial Companies, Article 79).[78]

6.1.2.2 In the name of the company ('derivative action')

As a subsidiary resource, a derivative action may be brought by shareholders owning at least 5% of the share capital or, in the case of stock corporations with securities admitted to trading on a regulated market, 2%, in order to claim damages in favour of the company for the loss suffered (*ut singuli*) (Code of Commercial Companies, Article 77(1)). The shareholders have to be shareholders at the time when the derivative action is brought. Their capacity to bring an action when the facts that give rise to the liability occurred is irrelevant.[79]

The derivative action is only permissible if the company decided not to bring the corporate action (Code of Commercial Companies, Article 77(1)) or it failed to bring the action within six months. After being instigated, the company may proceed with the action even if all claimant shareholders lose their capacity as shareholders or give up the action (Code of Commercial Companies, Article 77(3)). The claimant shareholders shall bear the legal expenses and no reimbursement is owed by the company (Code of Commercial Companies, Article 77(2)). If the defendant director alleges that the plaintiff brought the action to pursue interests not legally protected, he can ask for a ruling on the matter or for a guarantee to be given (Code of Commercial Companies, Article 77(5)).

6.1.3 Action brought by the creditors

Under Portuguese law, creditors are entitled to bring two different types of action. Firstly, creditors may bring a direct action against the directors as owners of a right to compensation. For such an action, the following requirements should be fulfilled: breach of a legal or contractual provisions aimed at protecting creditors (for example, the rules on the maintenance of the share capital, acquisition of own shares, delimitation of the legal capacity of the company and mandatory declaration of the insolvency under certain circumstances);[80] the breach must be caused by the director's intentional or negligent conduct (the burden of proof is on the creditors); and the breach diminishes the assets of the company (direct loss to the company), which become insufficient to pay the outstanding debts (indirect loss to the creditors) (Code of Commercial Companies, Article 78(1)).[81] As the losses suffered by the creditors result from the losses suffered by the company, the creditors cannot ask the directors for damages higher than the amount of the corporate assets lost by the company.

[78] The concept of "direct loss" has been clarified by the case law as only including the loss suffered directly by the assets of the shareholders or third parties. Indirect losses caused by the direct loss suffered by the company are excluded from this action (see the decision of the Court of Appeal of Lisbon in case nº 6603/2007-7, available at: http://www.dgsi.pt/jtrl.nsf/33182fc732316039802565fa00497eec/dcac28a26be0593680257369004ea9e0?OpenDocument).

[79] As argued by Jorge Manuel Coutinho de Abreu, *Código das Sociedades Comerciais em Comentário* (volume I, Almedina, 2010) 888.

[80] The breach of the duty of care or the duty of loyalty does not directly protect creditors and, thus, they cannot sue directors directly based on such duties (as decided by the Court of Appeal of Lisbon, in case nº 26108/09.9T2SNT-A.L1-2, of 13 January 2011: <http://www.dgsi.pt/jtrl.nsf/33182fc732316039802565fa00497eec/5baa5ab5dcebba1f8025781d005b7e66?OpenDocument&Highlight=0,dever,de,dilig%C3%AAncia,dever,de,lealdade,administrador>). This means that the Portuguese business judgement rule is not applicable in cases of creditor lawsuits.

[81] These criteria were clarified by the Court of Appeal of Porto in case nº 0421545, available at: http://www.dgsi.pt/jtrp.nsf/c3fb530030ea1c61802568d9005cd5bb/437c036684f21f1f80256e8500477875?OpenDocument.

Secondly, if an action against the directors in favor of the company is neither brought by the company – the company decided not to bring the action or failed to bring the action within six months (action *ut universi*) – nor by the shareholders through a derivate action (action *ut singuli*), the creditors can exercise the company's rights if the increase in the corporate assets thus achieved is essential to pay or guarantee their claims (Code of Commercial Companies, Article 78(2), and Civil Code, Articles 606 to 609). If the company or the shareholders bring such action, the creditors are not entitled to this right.

6.1.4 Action brought under insolvency proceedings

During the insolvency procedure the legitimacy to bring a corporate liability action belongs exclusively to the insolvency administrator (Code of Insolvency, Article 82(2)). In this case, no decision of the general shareholders' meeting is required to sue the directors.

6.1.5 Action brought by the subsidiary company or its shareholders

In groups of companies formed through subordination agreement or total domination, in the event of losses suffered by the subsidiary company, an action against the parent company may be brought by the subsidiary company or by any of its shareholders on behalf of the company (in this case no minority threshold is required) (Code of Commercial Companies, Article 504(2)). Creditors are also entitled to exercise the company's rights and bring the action if the company refrains from doing so, and the exercise of the company's rights is essential to pay or guarantee the creditors' rights (Civil Code, Articles 606 to 609).

6.2 Criminal and administrative sanctions

6.2.1 Criminal sanctions

The Criminal Code prescribes criminal liability of the directors in the following situations: (a) acts that are prejudicial to the creditors' interests if a fraudulent bankruptcy occurs (Criminal Code, Article 227); (b) frustration of debts after a condemnatory judgement in order to avoid the payment of the debts in an enforcement procedure (Criminal Code, Article 227-A); (c) negligent bankruptcy (Criminal Code, Article 228); and (d) preference of creditors where the director knows that the company is insolvent or that such insolvency is imminent (Criminal Code, Article 229).

Despite the numerous criminal sanctions, Portuguese courts tend not to apply them when analysing directors' liability.

6.2.2 Sanctions in the event of culpable insolvency

After insolvency proceedings have been commenced either by the director or another person legally authorised and the court finds that the company is insolvent, a procedure to classify the insolvency as fortuitous or culpable will ensue. Insolvency is culpable if it was brought about or aggravated by intentional or grossly negligent conduct of the company's *de facto* or *de iure* directors in the three years prior to the commencement of the proceedings (Code of Insolvency, Article 186(1)). However, to make it easier to prove whether or not the insolvency is culpable, the Code of Insolvency sets forth presumptions of culpability which are partly non-rebuttable (for example, the destruction of corporate assets or accounting fraud) and partly rebuttable (for example, the failure to file for the opening of insolvency proceedings or to submit the annual accounts (Article 186, (2) and (3)).

The classification of the insolvency as culpable due to willful or grossly negligent conduct of directors may lead to the disqualification of the directors for a period between two and ten years. During this period the directors cannot engage in trading activities or perform any functions in the corporate bodies of a civil or commercial company, association, private foundation with an economic activity, public enterprise or cooperative (Code of Insolvency, Article 189(2)(c)). The disqualification is registered at the Civil Registry Office. Moreover, directors lose any right to amounts owned as insolvency creditors and have to reimburse the amounts already received (Code of Insolvency, Article 189(2)(d)).

7 CONFLICT OF LAWS

7.1 Classification under Portuguese private international law

Under Portuguese private law, the law applicable to legal persons or collective entities governs "the capacity of the collective entity; the functioning and competence of its corporate bodies; the ways to acquire and loose its rights and duties; the liability of the collective entity, as well as that of its corporate bodies and members, towards third parties; the transformation, winding up and extinction of the collective entity" (Civil Code, Article 33(2)). The relationship between the collective entity and its members and between the members regarding corporate matters, as well as the special regimes on the liability towards the creditors and third parties, are regulated by such law.[82] Thus, the duties of directors are classified as company law for purposes of private international law.

The main duty in the vicinity of insolvency, the duty to commence insolvency proceedings, is classified according to private international insolvency law.[83]

7.2 Applicable law

7.2.1 Company law

According to Article 3(1) of the Portuguese Code of Commercial Companies, a company is governed by the law of the state where its main and effective centre of administration ("real seat") is located. The statutory seat of the company, however, has also some relevance: according to the second sentence of Article 3(1), a company with its statutory seat (i.e., the seat as indicated in the articles of association, usually the registered office) in Portugal cannot invoke, as regards relationships with third parties, the application of a foreign law (namely the law of a foreign country where the company has its real seat).[84] Therefore, in determining the law applicable to a company ("lex societatis"), the Portuguese Code on Commercial Companies combines the "real seat" with the "statutory seat/registered office".[85]

[82] Luís de Lima Pinheiro, *Direito Internacional Privado, Direito de Conflitos, Parte Especial* (volume II, 3rd Edition, Almedina, 2009).
[83] The duty regarding the loss of half of the share capital is a company law matter (see above 5), provided for in the Code of Commercial Companies (Article 35).
[84] In other words, companies with their centre of administration and control ("real seat") in a foreign country, but with their registered office in Portugal, cannot invoke the law of such foreign country against third parties. This special rule intends to protect the appearance: If the company's articles of association state that the registered office is in Portugal, third parties may assume that the company's real seat is also located in Portugal and thus that the applicable law is Portuguese law (cf. Rui de Moura Ramos, *Aspectos Recentes do Direito Internacional Privado Português*, in: "Estudos em Homenagem ao Prof. Doutor Afonso Rodrigues Queiró", Vol. I (Coimbra Editora, 1989), at 404 f., and Rui Pereira Dias, Código das Sociedades Comerciais em Comentário, Vol. I (Almedina, 2010), at 74 f.). Although, literally, this rule only applies if the registered office is located in Portugal, some argue that it may operate in a bilateral way, since it aims at protecting third parties and not national interests vis-à-vis international ones (Luís de Lima Pinheiro, *O Direito Aplicável às Sociedades – Contributo para o Direito Internacional Privado das Pessoas Colectivas*, in: "Estudos de Direito Internacional Privado, Direito de Conflitos, Competência Internacional e Reconhecimento de Sentenças Estrangeiras" (Almedina, 2006), 87).
[85] Luís de Lima Pinheiro, *O Direito Aplicável às Sociedades – Contributo para o Direito Internacional Privado das Pessoas Colectivas*, in: "Estudos de Direito Internacional Privado, Direito de Conflitos, Competência Internacional e Reconhecimento de Sentenças Estrangeiras" (Almedina, 2006), 87.

Nevertheless, Portuguese academic writing and legal practice are well aware of the impact of the *Centros/Überseering/Inspire Art* "trilogy" of judgments of the European Court of Justice on the determination of the law governing companies incorporated in one EU Member State, but having their centre of administration and control in another Member State.

With respect to a company incorporated in a Member State of the EU (at least, if that Member State adopts the incorporation theory), it is now generally recognised, both in legal practice and academic writing in Portugal, that the "*lex societatis*" of an EU company will be the law of its Member State of incorporation (where its registered office is located), even if that company has its main centre of administration (real seat) in Portugal. One may say that Article 3(1) of the Portuguese Code of Commercial Companies has therefore been reinterpreted and applied in conformity with the *Centros/Überseering/Inspire Art* jurisprudence. Moreover, it is worthwhile to mention that, according to Portuguese legal practice (i.e. notary and register practice), foreign companies with a registered office in an EU Member State are considered to be governed by the law of that Member State of incorporation, irrespective of where the centre of administration and control (real seat) is situated (even in the case of the real seat being situated in Portugal). This is so because Portuguese authorities, in practice, do not allow, as a rule, to bring evidence of any divergence between the "real seat" and the registered office when deciding on the law applicable to the company.

With respect to non-EU foreign companies, the doctrine of the "real seat", provided for by Article 3(1) of the Code of Commercial Companies, remains, as a matter of principle, applicable. It has been pointed out, however, that there are apparently no court decisions in Portugal in which the law of the state where the company's real seat is located was applied to the detriment of the law of the state of the company's registered office/statutory seat, which thus will tend to prevail in practice.[86]

The Code of Commercial Companies also contains some rules on the *international transfer of a company's seat*. In essence, companies may transfer their seat both to Portugal (inbound transfer) and from Portugal (outbound transfer) while maintaining their legal personality, provided that certain requirements are fulfilled. The inbound and the outbound cross-border transfer of the real seat of the company alone is permitted, without the company's loss of legal personality, since a divergence between the real seat and the statutory seat of a company is permissible under Portuguese law. Due to the strong presumption of coincidence between the company's statutory seat and real seat, a company will, as a rule, continue to be subject to the law of the state where the statutory seat/registered office is situated.

With respect to the *inbound transfer* of the real seat, Article 3(2) and (3) of the Code of Commercial Companies provides that a foreign company may transfer its real seat to Portugal, while retaining its legal personality. Despite the fact that Article 3(2)-(5) only mentions the inbound and outbound transfer of the real seat, it might be assumed that, for the Portuguese legislator, the transfer of the real seat presumably goes together with the transfer of the statutory seat/registered office, since the latter is the only seat subject to the Commercial Registry. Be this as it may, according to Article 3(2), an inbound transfer of the real seat is subject to the requirements that the law of the state of origin permits the transfer and that the company's articles of association are adapted in accordance with the laws of Portugal. In Portuguese academic writing it has been pointed out that the latter requirement is incompatible with European Law, in particular with the interpretation of Articles 49, 54 TFEU adopted

[86] Luís de Lima Pinheiro, Direito Internacional Privado, Direito de Conflitos, Parte Especial, Vol. II (3rd Edition, Almedina, 2009), 138.

by the ECJ in decisions such as *Überseering*.[87] A pronouncement of the ECJ on this matter would thus be most welcome.

With respect to the *outbound transfer* of the real seat, Article 3(4) and (5) of the Code of Commercial Companies provides that a Portuguese company may transfer its real seat to another country while retaining its legal personality, to the extent that the law of that other country permits the transfer and the company complies with the Portuguese requirements for the outbound transfer, that is, the shareholders give their approval by a supermajority of 75% of the share capital (along with the right of exit of those shareholders who have not voted in favour of the resolution).

The cross-border inbound and outbound transfer of the *registered office/statutory seat* alone is also permitted, subject to the same requirements as mentioned above in the case of the transfer of the real seat (Article 3(2) to (5)). Such transfer of the registered office will trigger a change of the "lex societatis" and a change of the company's form (conversion) to Portuguese law in case of an inbound transfer.

A company with its registered office in Portugal is free to have its real seat in another EU Member State, while retaining its legal personality and its status as a company subject to Portuguese Law. The company is also entitled under Portuguese private international law rules, in accordance with the ECJ judgment in *Cartesio*, to transfer its registered office abroad (without having to be wound up) by converting into a company governed by the law of the state of destination.[88] The requirement that the state of destination must permit the transfer is to be interpreted in light of the case law of the European Union, namely by allowing a Portuguese company that intends to transfer its registered office (re-register) abroad to convert into a company governed by the national law of the Member State of destination, in the same manner that the state of destination enables companies established under its national law to convert while maintaining their legal personality (*VALE*).

With respect to foreign companies intending to transfer their registered office to Portugal (to re-register in Portugal), while maintaining their legal personality and becoming subject to Portuguese law, Article 3(2) and (3) of the Code of Commercial Companies appears to be in accordance with the ECJ jurisprudence, allowing the inbound cross-border transfer of the registered office/conversion into a Portuguese company.

Finally, a special rule in Article 4 of the Code of Commercial Companies sets forth that a foreign company which does not have its real seat in Portugal, but wishes to perform business activities in Portugal for more than one year, must establish a *permanent representation* in Portugal and comply with the Portuguese commercial registry laws. Failing to do so, the foreign company shall be bound by the acts carried out on its behalf in Portugal and is jointly liable with the persons carrying out those acts and with the company's managers or directors (Code of Commercial Companies, Article 4(2)).

[87] Maria Ângela Bento Soares, *A Liberdade de Estabelecimento das Sociedades na União Europeia,* in: "Temas de Integração" (no. 15 and 16, Almedina, 2003), 319 to 321. Differently, Dário Moura Vicente, *Liberdade de Estabelecimento, Lei Pessoal e Reconhecimento das Sociedades Comerciais*, in: "Estudos em Memória do Professor Doutor António Marques dos Santos", Vol. I (Almedina, 2005), 153 to 158, and Luís de Lima Pinheiro, *Direito Internacional Privado, Direito de Conflitos, Parte Especia*l, Vol. II (3rd Edition, Almedina, 2009), 171 to 172, argue that Article 3(2) is fully in conformity with European Law.

[88] On the impact of Cartesio, see António Frada de Sousa, *A Company's Cross-border Transfer of Seat in the EU after Cartesio*, Jean Monnet Working Paper 7/09 (2009), 52, and Rui Pereira Dias, *O Acórdão Cartesio e a Liberdade de Estabelecimento das Sociedades*, in: "Direito das Sociedades em Revista" (2, 2010), 235 to 236.

Upon the request of any interested party or the Public Prosecution Service, the court may order the company to cease its activities in Portugal and liquidate any assets located there (Code of Commercial Companies, Article 4(3)). The purpose of this special legal provision is, apparently, to provide protection to third parties who enter into contractual relations with the foreign company. It is argued, however, that these limitations on the performance of business activities by foreign companies in Portugal are not applicable to EU companies, which benefit from the right of establishment[89] and the right to provide services within the EU.[90]

7.2.2 Special duties in the vicinity of insolvency

In relation to insolvency law matters, Regulation (EC) no. 1346/2000 of 29 May 2000 on insolvency proceedings is applicable. As a general rule, the insolvency proceedings and their effects are governed by the law of the Member State within the territory of which such proceedings are opened (Article 4(1)). The reach of this general rule is defined in Article 4(2). As to certain matters, such as contracts of employment and contracts relating to immovable property, specific conflict of law provisions apply (Articles 5 to 15). The situations not governed by the Regulation are subject to the regime contained in the Code of Insolvency (Chapter XV), which is in line with the Regulation.

[89] See, in this sense, Rui Pereira Dias, *As Sociedades no Comércio Internacional* (Problemas Escolhidos de Processo Civil Europeu, Conflitos de Leis e Arbitragem Internacional), in IDET – Miscelâneas (5, Almedina, 2008), 79 to 81.
[90] Doubtful in this regard, Luís de Lima Pinheiro, Direito Internacional Privado, Direito de Conflitos, Parte Especial, Vol. II (3rd Edition, Almedina, 2009), 156 to 157, who, in any case, considers, at the end, that Article 4 of the Code of Commercial Companies, due to its purpose of providing adequate protection to third parties, is in conformity with EU law.

Enterprise

DIRECTORS' DUTIES AND LIABILITY IN ROMANIA

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Contents

1 INTRODUCTION

1.1 Corporate law and directors' duties in Romania

The Romanian legal system belongs to the civil law systems, under which only the Constitution and other statutory legislation constitute a legitimate source of legal rules. Formally, the Romanian legal system does not recognise case law or judicial precedent as a source of legal rules. Previously decided cases are therefore not binding upon lower courts and do not create "law". The doctrine only provides guidance as to possible analogies where the law is silent. The "Companies Act no. 31/1990" (Legea Societatilor Comerciale no. 31/1990) was the first pillar of the corporate governance system in Romania. The law was inspired by the continental model and the Romanian Commercial Code, and has undergone a series of modifications since it came into operation. For example, Regulation (EC) 2157/2001 has been implemented through law no. 441/2006, which modified the existing law regarding public limited companies. One of the major impacts of this law was generated by the introduction into the Romanian legal framework of the two-tier board system, as well as of other provisions regarding the winding-up, liquidation and merger of companies irrespective of the form they are organised in.

Under the law there are five types of companies: partnerships, limited partnerships, partnerships limited by shares, public limited companies and limited liability companies. Nevertheless, the law makes a clear-cut distinction between private and public companies as they are dealt with in different chapters. Chapter IV of the law is entirely dedicated to public limited companies. Under this chapter, the following sub-chapters can be found: (i) Shares; (ii) General shareholders Meetings (GSMs); (iii) Board of directors; (iv) Censors; (v) Bonds; and (vi) Registries and the balance sheet. In the case of public limited companies and limited liability companies, the shareholders' liability is limited to the amount invested, i.e. the subscribed share capital. Due to the advantages they offer, these are the most common types of companies used in Romania.

The duties and obligations of the directors of listed companies are regulated in Law no. 297/2004 regarding capital markets. This law regulates the National Securities Commission (CNVM-Comisia Nationala a Valorilor Imobiliare), the establishment and functioning of the capital markets, together with the institutions and operations specific to such markets. The CNVM (the Romanian equivalent of the FSA UK) is organised based on the Government`s Emergency Ordinance no. 25/2002. Other major provisions regarding this field can be found in secondary regulations, especially Regulation no. 1/2006 and Regulation no. 6/2009 issued by CNVM.

In addition, board members must observe the provisions regarding the board of directors contained in the by-laws or statute of any public limited company, the rules and procedures applicable to publicly traded companies issued by the National Securities Commission, and the rules and procedures of the Bucharest Stock Exchange (BSE) or RASDAQ, in particular the Code of Corporate Governance issued by the BSE. Also of interest are the provisions in the New Civil Code regarding tort and contractual liability and, last but not least, the Insolvency Law no. 85/2006 (Legea insolventei, no. 85/2006).

Since October 2011, the Commercial Code no longer exists, except for a few provisions regarding proofs in commercial litigation and other aspects. Instead, the lawmakers decided to unify the private law regime by passing the New Civil Code, which embeds provisions applicable both to professionals and simple individuals.

Despite this unification, there are still certain parts of the New Civil Code[1] which apply mainly to companies, such as the rules on 'the administration of the property of others' (Articles 792 to 857, which now constitute the default legal regime for all administration operations, including the administration of companies). There are also numerous former commercial contracts which were regulated in the Commercial Code or other laws and are now governed by the rules contained in the New Civil Code. A distinct but important set of rules regarding the private law relations can be found in the implementing regulation of the New Civil Code.[2]

Moreover, through Ordinance no. 20/2001 the administration of national companies and other companies where the state or a public authority is the majority shareholder is aligned with the provisions of the Companies Act.

A recent government ordinance which is of foremost interest in this field is Ordinance no. 109/2011 regarding the Corporate Governance of State Owned Enterprises. The main precept arising from this regulation is the privatisation of the corporate management of state-owned enterprises following a transparent process.

Finally, special provisions remain in existence for the financial banking and insurance sectors[3] and for financial investment funds (SIF).

1.2 Corporate landscape in Romania

Initially, the ownership structure of Romanian companies was dispersed, which was a legacy of the privatisation program of the mid-1990s. Today, most listed companies have one or more controlling shareholders. At the end of 2011, capitalisation of the regulated market of the Bucharest Stock Exchange (Bursa de Valori București S.A.) was EUR 10.8 billion, larger than CEESEG Ljubljana, Slovenia and Budapest. seventy-nine companies were listed on the regulated market, ahead of the stock exchanges of Sofia/Bulgaria, Prague/Czech Republic, Budapest/Hungary and Ljubljana/Slovenia.[4] The firms listed on RASDAQ tend to be dominated by employees associations or the state and include several thousand minority shareholders.

The state plays a major role in the shareholder structure of many companies. Romania does not have a single privatisation agency entitled to manage the state's participations in the economy. This function is accomplished by two governmental entities. The first one is the Authority for the Exploitation of State Assets (Autoritatea pentru Valorificarea Activelor Statului - A.V.A.S.), which at the end of 2011 was holding a portfolio of 689 companies, from which 338 were involved in winding-up or liquidation procedures and the rest were subject to privatisation. The second governmental entity is

[1] Law no. 287/2009 regarding the New Civile Code published in the Official Gazette no. 505/15.07.2009.
[2] Law no. 71/2011 published in the Official Gazette no. 409/10.06.2011.
[3] Ion Traian Stefanescu, Serban Beligradeanu, 'Natura Raportului Juridic dintre Societatile Comerciale si Administratorii sau Directorii Acestora', *Dreptul*, no. 8/2008, pp. 66.
[4] Bucharest Stock Exchange Annual Report 2011 (Bursa de Valori București S.A. Raport anual 2011), pp. 12, available at http://www.bvb.ro/info/Rapoarte/Anuale/BVB-Raport-anual-2011-web.pdf.

the Office of State Participations and Privatization in the Industry (Oficiul Participaţiilor Statului şi Privatizării în Industrie - O.P.S.P.I.). It is subordinated to the Ministry of Economy and deals with a number of companies not yet fully privatised, holding a portfolio of companies from gas, electricity and military industries in which the Romanian state is the sole or majority shareholder, or in which it retains a shareholding after the conclusion of the privatisation process[5].

Also relevant for the present report is a brief presentation of the Romanian capital market. Nowadays, the capital market is formally organised under a system derived from the US. The regulator is the National Securities Commission. The main institution of the Romanian capital market is the Bucharest Stock Exchange (Bursa de Valori București S.A.), which operates the capital market. The latter is divided into three sections: (i) BVB, which is a regulated market pursuant to MiFID provisions; (ii) RASDAQ, which is not a regulated market,[6] but is comparable to the US NASDAQ; and (iii) ATS - CAN, which is a an alternative trading system (ATS) or, in terms of MiFID, a multilateral trading facility (MTF). The traded securities are mainly shares, but also a few local municipality bonds and corporate bonds.[7] Another less prominent market operator is SIBEX - Sibiu Stock Exchange S.A. (the former Monetary Financial and Commodities Exchange located in Sibiu - Bursa Monetar Financiară și de Mărfuri S.A. B.M.F.M. S.A.).[8]

1.3 The board of a Romanian company

The above mentioned legal setting defines the duties and liabilities of directors of the Romanian public limited company (societate pe actiuni). The creation of a public company requires a minimum capital of 90,000 RON[9] and at least two shareholders. Romanian law provides for two alternative possibilities to organise the board structure of public companies, the one-tier system, which is the more traditional and widespread model, and the two-tier system. The Companies Act grants shareholders the right to choose between these two governance models. The one-tier system is regulated in articles 137-152[1] of the Companies Act and the two-tier system in articles 153-153.[11] In addition, several common provisions are contained in articles 153-158.[12]

Under the one-tier system, the administration of a company limited by shares is assumed by a board of directors. Even though the governance structure lacks a supervisory board, the one-tier model implements a number of features that aim at the separation of management and control. The majority of board members must be non-executive directors, with prerogatives limited to the supervision and monitoring of the managers. Managers may or may not be members of the board (executive directors).

The law allows the founders or the general meeting of shareholders to decide on the number of directors that the company shall have. A company may have a sole director, although in this case the

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[5] The portfolio of the Office of State Participations and Privatization in the Industry (Oficiul Participaţiilor Statului şi Privatizării în Industrie - O.P.S.P.I.is available at http://opspi.minind.ro/portofoliu.html.

[6] A recent decision of the Court of Justice of the European Union in the case C–248/11 is worth mentioning as it states that RASDAQ can be qualified as a regulated market only if it meets the standards set out in Title III of MiFID, implicating that RASDAQ is an alternative trading system to which capital markets regulations do not apply - Case C–248/11 *Criminal proceedings against Rareș Doralin Nilaș, Sergiu-Dan Dascăl, Gicu Agenor Gânscă, Ana-Maria Oprean, Ionuț Horea Baboș*, OJ C 133/10.

[7] Victor Dragotă *et al.* 'The Development of the Romanian Capital Market: Evidence on Information Efficiency' Romanian Journal of Economic Forecasting, no. 2/2009.

[8] http://www.sibex.ro/.

[9] Approximately 20,000 Euro.

issue arises whether the administration is in conformity with the general principle of corporate governance demanding a clear separation of the executive and control functions in the company.[10] In case of a plurality of directors, the number should be odd in order to avoid deadlocks. Unless they were appointed by the constitutive statute, the directors are appointed by the general meeting of shareholders for a maximum mandate of four years with the possibility of being re-elected. The persons eligible for the seat are nominated by the current members of the board or by the shareholders.

The board has the authority to delegate the management to one or more managers.[11] The delegation of powers is mandatory in case the company is subject, under the law, to external audit. In case of such delegation of powers, the managers are the persons who conduct the daily business activities and the company is represented by the general manager.[12] In contrast to the members of the board who can be legal persons, the managers have to be natural persons. The board of directors supervises the activities of the managers and also retains some powers that cannot be transferred to the managers, such as: setting the key directions of the company's activity, preparing the annual report, organising the general meetings of the shareholders and implementing their decisions.

The two-tier system consists of two separate boards: the management (or executive) board, which is responsible for the day-to-day business, and the supervisory board, which controls the activities of the executive board. The management board may be composed of one or more members who have to be natural persons. In case of more than one member, their number must always be odd. Similar to the one-tier system, the management board must have a minimum of three members when the company is subject, under the law, to an external audit. The members of the management board are appointed and removed by the supervisory board. The management board conducts the daily business operations of the company and represents it in relation to third parties. Unless otherwise provided by the articles of association, the members of the executive board represent the company by acting together and signing jointly. Nevertheless, by their unanimous agreement, they can appoint one of them to conclude specified commercial operations. The supervisory board has the role of supervising the activities of the management board and reporting to the general meeting of the shareholders. Its members are appointed and removed by the articles of association and then by the general meeting of shareholders. Their number cannot be less than three and cannot exceed eleven. In addition, they cannot be at the same time members of the management board.

[10] St. Carpenaru, C. Predoiu s.a., Legea societatilor comerciale, ed. CH Beck, ed. a IV-a, comment of article 137.
[11] Under the Romanian corporate law terminology, the members of he board are called *administrators*, while the persons vested by the board with executive management powers are referred to as (executive) *directors*. For this reason, there is a high risk that issues concerning the administration create terminological confusions when translated into English.
[12] Alexandru Ticlea, Tiberiu Ticlea, 'Particularitati ale contractului de mandat comercial al directorilor societatilor comerciale pe actiuni', Dreptul, no. 8/2010, pp. 77-98.

2 Concept of Company Director in Romania

2.1 De iure director

2.1.1 Requirements to become a *de iure* director

The procedure for the appointment of natural or legal persons as directors depends on whether the appointment takes place at the time of formation of the company or at a later stage when the company is operating. The principle underlying the appointment of directors, both under the old regulations of the Commercial Code and the current provisions of the Companies Act, is that the appointment falls within the powers of the general meeting of shareholders. In public limited companies, directors are appointed pursuant to article 111 of the Companies Act by the ordinary meeting of the shareholders. The first members of the board shall be identified in the articles of association, which shall also specify the powers given to the directors and the managers. The directors are elected for a maximum mandate of four years with the possibility of being re-elected. The law requires that the majority of the directors shall be made up of non-executive directors whenever there is a case of delegation of powers from the board of directors to the managers.[13] In addition, the law allows companies to include in their by-laws provisions regarding the number of independent directors on the board.[14] The independent and non-executive directors constitute preconditions of good corporate governance practice.

After the general meeting of shareholders has elected the board of directors the law prescribes the publication of the appointment of the directors. The name and the signature sample of the directors who have powers of representation must be registered with the Trade Registry (ORC, Oficiul National al Registrului Comertului).[15] The company cannot rely in relation to third parties on the appointment or termination of office of a director if the appointment or termination was not previously published. Starting from this rule, the legal literature and the courts have created the so-called “apparent director” doctrine, which is derived from the apparent mandate. This means that in certain restrictive situations a former director can legally bind the company because of the fact that third parties were unable to obtain knowledge of the termination of the director’s mandate.

After being elected, directors must expressly accept their appointment.[16] They are under an obligation to take out insurance to cover professional liability[17] and sign a contract of mandate which prescribes the terms of their performance, since directors are prohibited from concluding an employment agreement.[18] By specifically asking for the acceptance of the appointment by the director, the lawmakers inoculate the idea that the relation between the director and the company is mainly based

[13] Article 138[1] Law no. 31/1990
[14] Article 138[2] Law no 31/1990
[15] Article 18 Law no. 26/1990.
[16] Article 153[12] Companies Act.
[17] Article 153[12] Companies Act.
[18] There is however an exception to this rule for limited liability companies with one member in article 196[1] of Law no. 31/1990.

on a mandate.[19] Also, the Companies Act strictly regulates the financial assistance that the company may grant to its management personnel (directors, managers, members of the directorate or supervisory council) or the operations that can be concluded between them and the company. The remuneration established in the constitution or by the general meeting of shareholders has to be justified in light of the specific duties of directors and the company's economic situation. The provision of other financial benefits, loans, or guarantees by the company is prohibited.

2.1.2 Who can be a *de iure* director

The director of a public liability company may be either a legal or natural person.[20] Once named as director the legal person must appoint a natural person as its representative. Access to the position of director is conditional upon the fulfillment of several requirements which may vary depending on whether the administrator is a natural or a legal person:

- The director represents the company in relation to third parties. Thus it is indispensable for the director to have full legal capacity.[21] There are no special provisions regarding the legal capacity of directors. Therefore, the rules of the Civil Code apply. Thus, a natural person has to be above 18 years old and not adjudicated for incapacity by a court.

- A second condition regards the worthiness of the director and the lack of previous criminal convictions. This stems from the Companies Act, which states that any person can participate in the creation of a company, provided that he/she was not condemned for specific criminal offences stipulated in the law.[22]

- There are no longer restrictions regarding the citizenship of the directors. Until 2003 half of the members of the board of directors had to be Romanian citizens.[23]

- There is no precondition to be a shareholder in order to qualify for the position of director. Before 2006, the Companies Act, following the French model, contained this requirement.

- There is an express prohibition of cumulating the position of director with that of employee of the public limited company.

- There is a limitation of the number of mandates a natural person can exercise. According to the Companies Act, a natural person can only concomitantly be a director in five public limited companies that have their headquarters on the territory of Romania.[24] This limitation does not apply when the person in question owns at least a quarter of the total number of shares, as the directors will have an incentive to perform their duties with competence. If the director is a legal person there is no longer a limitation of the number of public limited companies it can act as a director for.

[19] Gh. Piperea, Drept comercial, vol. I, ed. CH Beck, p. 202.
[20] Article 153[13] Companies Act.
[21] Articles 6, 135, 136, Law no. 31/1990.
[22] Article 6 Companies Act, 'The persons who have been convicted of fraudulent management, breach of trust, forgery, fraud, embezzlement, perjury, giving or taking bribes, as well as the offences established in Articles 143-145 of Law no. 85/2006 on insolvency proceedings, or those provided by the Companies Act.'
[23] Viorel Papu, 'Dobandirea Calitatii de Administrator al unei Societati Comerciale pe Actiuni', *Revista Romana de Drept al Afacerilor*, no. 7-8, 2004.
[24] Article 153[16] Companies Act.

- The function of director is incompatible with the exercise of several professions. These incompatibilities are expressly provided for by law. For example, Law no. 303/2004 on the status of magistrates provides that judges are forbidden to participate in the administration or management of companies. Also, lawyers are not allowed to participate directly in the management of a company (article 29 of Decision no. 64/2011 of the National Bar Association). Public servants cannot hold any position in a company under article 56 (2) of Law no. 188/1999.

2.2 *De facto* and shadow directors

The concept of a '*de facto*' director is not defined, but appears in different legislative instruments regarding contraventions[25] and civil liability towards the company. The insolvency law states that besides the directors any other person that caused the insolvency of the debtor can he held liable.[26] In this context the concept was developed by the courts.[27] The distinction between a '*de facto*' and a shadow director is not entertained by the Romanian courts, and as such both are treated under the same notion. Under the insolvency law previously mentioned, the jurisprudence equated the liability of '*de facto*' directors with that of '*de iure*' directors. It was held that the law makes no distinction between directors in office and those whose membership has ceased, so that, in principle, both can be held liable.[28] An administrator removed from office, whether or not the dismissal was noted in the Trade Register, can be held liable under the same conditions as one in office. The same conditions apply in the case of persons who overwhelmingly influenced the company's activities.

In the case of a board of directors whose liability is in principle joint, if it turns out that one of the directors had no knowledge of a decision taken by a '*de facto*' director or did not follow the decision of the board, she is exempted from liability. Courts have found people liable as *de facto* directors who exercised functions in the management chain such as commercial directors or technical consultants.[29]

[25] Article 112 Law no. 52/1994 regarding securities and stock exchanges.
[26] Article 138 Insolvency Law.
[27] Gheorghe Piperea, 'Obligatiile si raspunderea administratorilor societatilor comerciale', All Beck, 1998, pp.6-10.
[28] *Tribunal Cluj, Decision no. 48/2004.*
[29] Court of Appeal, Craiova, Decision no. 109, 22.02. 2007.

3 SCOPE OF DIRECTORS' DUTIES UNDER ROMANIAN LAW

3.1 Overview

Article 72 of the Companies Act states that the duties and liability of directors are governed by the provisions regarding the mandate and those specifically provided for in the law. The legal relations between the company and the director are governed by the commercial mandate, not by legal representation, which is just one of the obligations of the agent-director.[30] Being charged with managing a commercial business in the name and on behalf of the company, directors exert a commercial mandate. This contract is governed by the rules regarding the mandate from the New Civil Code, which are complemented by the provisions referring to "the administration of other persons" assets'. Although we can no longer talk about a commercial mandate since the entering into force of the New Civil Code, it is still possible to refer to a mandate concluded between professionals, because the new legislation includes a few specific rules applicable only when the activity for which the mandate is given is of a professional nature.

The duties of the directors are owed to the company, whether we are talking about an *in bonis* company or about one which is insolvent. Only exceptionally can the shareholders and third parties ask for compensation directly from the directors for losses caused by their activity/inactivity based on tort liability.

If the director is elected by the shareholders, he/she must refrain from taking part in any vote of the general meeting which is in connection with his quality of director (article 127 of the Companies Act).

The time span of the directors' duties is usually limited to the period of time they are in office. The duty of confidentiality, by exception, remains in effect after the management contract has been terminated for a limited period of time established in the agreement.

3.1.1 Employment relations

The law prohibits directors from being both directors and employees of a company. Consequently, any existing employment will be suspended. The prohibition refers to any employment contract, even if unrelated to the duties of a director. In conclusion, directors cannot cumulate their role as director with that of employee or receive a salary from the company. An exception to this rule is the case of a limited liability company with a sole associate who can then cumulate the functions of director and employee.[31] Therefore, in principle, the director will have contractual duties (deriving from the commercial mandate) and, in addition, legal duties (following the conclusion between the director and

[30] Gheorghe Piperea, 'Obligatiile si raspunderea administratorilor societatilor comerciale', All Beck, 1998, pp.6-10.
[31] Article 196 par. (3) the Companies Act.

the company, represented by the general meeting, of the mandate). The liability of the director will thus be contractual (breach of the commercial mandate) or tortious (breach of legal obligations).

3.1.2 Doctrinal interpretation

Nevertheless, the doctrine has observed that qualifying the relation between the company and the director only on the basis of the mandate is inaccurate. This stems from the fact that there are powers that belong to the directors but not to the general meeting of shareholders. Consequently, they could not have been delegated by the shareholders to the directors. This does not fit well with the notion of a mandate, as it is characterised by a delegation of powers.[32] The fact that the general meeting of shareholders has the power to revoke the mandate *ad nutum* stems from the law and not from the mandate between the company and the director. For the conclusion of such a contract, there have to be two distinct wills, but the company does not have one in the absence of a representative. Thus, the director is an organ of the company in charge of management and representation. This suggests the lack of a subordinate relationship between the general meeting of shareholders and the director, and also gives the director a high degree of freedom as the Commercial Code extends the limits of the mandate to all acts necessary for the execution of the business. Thus, the director has a high degree of autonomy, which allows him to take the best decision in light of the circumstances. The mandate also reflects a relation based on trust; it can be stated that, flowing from the rules on the mandate, the relation between the company and the director is of a fiduciary nature. This is supported by the latest reforms of the Companies Act which introduced the duties of loyalty, care and caution and confidentiality.

3.1.3 Organ Theory

The organ theory, which states that the director has a function endowed with both legal and contractual powers, supplements the rules on the mandate by increasing the accountability of directors. Thus, directors do not only manage and represent others persons' interests, but hold a position with duties that they have to exercise in the interest of the company, shareholders and stakeholders. Taking into consideration the interest of the stakeholders, however, is a minority opinion not entertained by the majority of commentators.[33]

3.2 Types of duties

Directors' liability arises if they breach obligations established by law or by the articles of association or if they exercise the mandate by breaching the fiduciary obligations which derive from it.[34] As such there are two types of duties: fiduciary duties and statutory duties. The fiduciary legal relationship stems from the contract on the mandate as determined by the New Civil Code; the fiduciary duties derive from the provisions on the mandate, the Companies Act, and the articles of association.

[32] St. Carpenaru, 'Drept Comercial Roman', Universul Juridic, Bucuresti, 2007.
[33] S. David. F. Baias, Raspunderea juridica a administratorilor societatilor comerciale, [Civil liability of a company director] Dreptul nr.8/1992, p.13
[34] Radu Catana, 'Dreptul Societatilor Comerciale. Democratia actionariala' [Company Law. Sharholders' democracy], Sfera Juridica, Cluj Napoca, 2007, p.162.

The Companies Act expressly lays down in article 73 the duties for which directors are jointly liable to the company. These are:

1) the duty to ensure that the equity has been paid in by the shareholders;
2) the duty to ensure that dividend payments are justified;
3) the maintenance of proper records as required by law;
4) the fulfilment of resolutions of the general meeting of shareholders;
5) the strict fulfilment of the duties which the law and the articles impose;

Fiduciary duties include the duty *to act in good faith and for a proper purpose, and the* duty *of care and skill,* which will be presented in the next chapter.

Article 73 of the Companies Act furthermore states that the directors are jointly liable to meet all obligations prescribed by the law and the articles of association. The most important statutory duties are presented below:

1) The obligation to fulfil the formalities for setting up the company;
2) to manage the company in order to fulfil the purpose of the company, within the limits stipulated in the memorandum;
3) to represent the company (arising from the mandate);
4) to convene the general meeting of shareholders;
5) to monitor the payments of dividends to shareholders;
6) to keep the company records;
7) to prepare annual management reports, annual financial statements and ensure that dividends are distributed;
8) to take part in general meetings of shareholder; and
9) to carry out the decisions of the shareholders.

4 LIABILITY FOR BREACH OF DUTY

4.1 Overview

Following the French model of civil liability, the Romanian company law considers that directors are in principle contractually liable to the company, while they may be liable based on tort law in relation to the shareholders individually and to third parties. The principle of contractual liability towards the company derives from the agency (mandate) relationship that article 72 of the Companies Act refers to as the foundation of directors' duties and responsibilities. Nevertheless, some directors' duties are provided for specifically by the Companies Act and have no connection with the agency/mandate relationship (e.g. the duty to maintain the company's records, distribute dividends only from real net profits, or call the general meeting of shareholders to decide on the increase or decrease of the share capital in certain cases, etc.). This complexity and distinction with regard to the responsibilities of directors gave rise to the opinion holding that directors' liability to the company is tortuous for breach of purely legal obligations. Today, the legal literature almost unanimously agrees that directors' liability in relation to the company is contractual, but observes that the content of such a contractual relationship is either established by the common law of agency (fiduciary duties) or by specific provisions of the company law (statutory duties). As previously mentioned, it is most effective to divide duties into fiduciary and statutory duties. While the statutory duties are not problematic, the fiduciary duties will be presented in detail in the next section.

4.2 Fiduciary duties

Fiduciary duties are traditionally derived from the common law and the *intuitu personae* relationship which binds directors to the company. In other words, they are based on the idea of trust and confidence that underlies the agency (mandate) agreement. Although fiduciary duties were always considered to be inherent in the civil law of agency as regulated by the Romanian Civil Code from 1865, they were conceptualised and introduced as such only through the Companies Act reform from 2006 and reproduced in the new Romanian Civil Code from 2009.

4.2.1 Duty to act in good faith

The duty to act in good faith stems from the former Civil Code, article 970, and was reformulated by article 14 of the New Civil Code as a general duty to exercise rights and perform obligations in good faith, without harming or damaging other persons. According to Romanian contract law,[35] the duty of good faith is considered as the essence of the duty of loyalty, which in turn encompasses both the duty of disclosure and the duty of confidentiality.

[35] L. Pop, *Tratat de drept civil. Obligatiile, vol. II. Contractul* [Treaty of civil law. Obligations, vol. II, The Contract] , Universul Juridic, Bucuresti, 2009, p.513

4.2.2 The duty of loyalty

The duty of loyalty is expressly mentioned not only in the Companies Act,[36] but also in Article 803 par.2 of the New Civil Code, which has become the new common law for all relationships related to the administration of someone else's assets. It establishes a standard of behavior owed by the director to the company, which may give rise to an action for damages if the director fails to meet the standard. The duty consists of treating the business of the company fairly and honestly, promoting exclusively the interests of the company, avoiding conflicts of interest with the company, and refraining from promoting the directors' own interests at the expense of the company and from usurping corporate opportunities. The director has to act with a view to optimally realising the company's interests and to pursue only the purpose of the company.

The company's interests are not defined by the Companies Act or by the New Civil Code. Starting from the concept of the agreement establishing the company, the doctrine considers that the company's interest is the common, collective legitimate interest of the shareholders to a share in the profits.[37] Similarly, the Romanian highest court of law considers the company's interest to be represented by the common intention of the shareholders to associate with a view to obtaining profit, to follow a direction that promotes the entity's prosperity.[38] Thus, from a comparative perspective, Romanian company law does not seem to implement either the stakeholder model or the enlightened shareholder model proposed by section 172 of the UK Companies Act 2006.

The director cannot use his powers, nor the company's assets and credit, to pursue an objective that is contrary to the company's interests and that furthers his own interest or that of a third party. The sanction is damages and potentially criminal liability if the breach was in bad faith.[39]

4.2.3 Duty to act intra vires

The duty of loyalty encompasses the duty to act *intra vires*. The director is required to act within the limits of the mandate and the articles of incorporation. In civil law, an *ultra vires* operation would make the agent personally responsible in relation to the third party unless the principal ratifies the transaction. Company law embraces the "apparent agency theory" in order to protect good faith third parties who agreed to enter into a transaction beyond the limits of the directors' powers according to the company's articles of incorporation. Thus, if a company executive exceeds his/her powers, the company is considered responsible in relation to the good faith third party and can claim damages from the director if the transaction is harmful to the company.[40]

Related to the duty to act intra vires, article 44^1 limits the directors' right to dispose of company assets in the first two years since the formation of the company or the acquisition of assets by the company from the founders or shareholders valuing more than 10% of net assets. In these cases, the director is required to obtain the approval of the general meeting of the shareholders. This approval is also needed in the case of transactions which involve assets amounting to more than half of the book value

[36] Article 144^1 (4) Companies Act.
[37] See article 1881 of the Romanian New Civil Code, which enunciates the "view to share profits" as the cause of any company agreement. This doctrine is influenced by the neoliberal French doctrine of the "intérêt social" – see D. Schmidt, *Les conflits d'intérêt dans la société anonyme*, Ed. Joly, Paris, 1999, p.189-190.
[38] High Court of Cassation and Justice, dec, no. 4199 / december 2, 2010, published on the Court's web site: http://www.scj.ro/SE%20rezumate%202010/hot%204199_2dec2010.htm.
[39] Article 272 point 3 Companies Act.
[40] See article 55 and 73 par.1 point 3, Companies Act.

of total company assets.[41] Without shareholder approval the contract is void even if the third party could not have known that the value of the contract represented 50% of the company's assets.[42] Nevertheless, the general meeting of shareholders can subsequently ratify the act.

This duty is complemented by the obligation not to compete, which reinforces the concept that executive directors have to pursue the optimal and exclusive interest of the company.[43] The duty not to compete is subject to at least four observations, which limit its practical effects. Firstly, the legal provision refers only to executive directors and managers; non-executive members of the board are not bound by a statutory duty, but they may be subject to a contractual obligation not to compete. Secondly, owning or administrating a competing entity may be approved by the board, which may either grant a waiver or state that the executive director's parallel business activity does not represent a real, actual and unlawful act of competition. Thirdly, the broad field of this duty as set out by the black letter law is highly open to criticism. According to the law, the duty includes the obligation not to be a director in competing companies or in "companies pursuing the same type of activity".[44] Such broad scope was set forth in the original version of the Companies Act from 1990. Given the lack of relevant published jurisprudence addressing this issue for companies limited by shares, we believe that the courts must look for the reality and actuality of the competition, considering the concepts such as the "relevant market" from competition law and taking into account the fact that this duty is ultimately a component of the general duty of loyalty. Fourthly, the sanction in case of non-compliance does not consist in declaring the contract with the competing company void, but in finding the director liable to pay damages to the company, as well as dismissal from the position of director.

4.2.4 Duty of disclosure

The legal regime of interested transactions lies at the heart of the duty of loyalty. As a general principle, if directors have a personal interest in a particular transaction, they have a positive obligation to disclose the conflict of interest to the other members of the board and to the internal auditors, and a negative duty to refrain from voting.[45] The disclosure should indicate the nature and value of the personal interest (according to articles 805 and 806 of the New Civil Code). A conflict of interest exists also if the director is not personally interested, but a member of the director's family or his/her spouse's family.

In case the directors breach this duty, the interested transaction remains valid and has to pass the test of fairness in a court of law. If the test fails and the transaction is considered harmful to the company, for example, because it was not entered into at market value, the director is liable to cover the damages engendered to the company. The law does not consider the subscription of company shares or transactions conducted in the company's regular course of business as interested transactions that would trigger the above obligations.

Some interested transactions of particular significance are considered self-dealing and have been addressed by the legislator in detail. On the one hand, there is a clear prohibition of the company to

[41] Article 153^{22} Companies Act.
[42] Supreme Court, Decision no. 878/2005.
[43] Article 153^{11} Companies Act.
[44] Article 153^{15} Companies Act.
[45] Article 144^{3} Companies Act.

offer any financial advantages, loans, financial leasing, credit support, or provide security for the personal debt of a director.[46] On the other hand, if the director intends to acquire from or sell to the company assets that amount to more than 10% of net assets, he/she needs the approval of the general meeting of shareholders. If the approval is not procured the contract is null and void.[47] This requirement also applies to cases where one of the parties of the transaction is part of the director's extended family.

4.2.5 Duty of confidentiality

The duty of confidentiality provides that directors must not disclose confidential information and business secrets which they obtain in the exercise of their position in the company. This obligation must be respected for a reasonable period of time, or a period established by the articles of association, even after the termination of the director's mandate.[48]

4.2.6 Duty of diligence and prudence

The duty of diligence and prudence is expressly laid down in article 144^1 par. (1) of the Companies Act. The standard of care refers to the care and skill of a "good administrator".[49] This standard comprises the level of diligence, prudence and competence which would objectively be demanded from an abstract good administrator found in the particular business situation of the director. The law clearly sets out an objective and abstract standard; it does not refer to the knowledge, skill or experience that the director has, as, for instance, section 174 of the UK Companies Act.

The notion of the good administrator is not defined in the Companies Act. The doctrine defines the concept by reference to a hypothetical director with experience and knowledge specific for the respective line of business. Because the director is remunerated for his/her activity and for the trust that the company has in the director, he/she will be liable for culpable failure by reference to *cupla levis in abstracto*,[50] which is a high standard of conduct and review that applies to remunerated and professional agents.

4.2.7 The business judgment rule

Through a legal transplant from Delaware corporate law, article 144^1 par. (2) of the Companies Act provides that directors do not breach their duty of diligence and prudence if they were reasonably entitled to assume at the time of the business decision that they were acting in the interest of the company and on the basis of adequate information. Although this rule, introduced by the reform of the Companies Act of 2006, has not yet been applied in practice, it was conceived as a mechanism to protect managers from the jeopardy of personal liability for taking business decisions involving risks which are inherent in the business environment in a competitive market. Unlike her American source, the rule does not create a presumption in favor of directors; instead, it states that fault as a constitutive

[46] See article 144^4 Companies Act. However, it should be mentioned that such operations to the benefit of a director are permitted as long as the amount involved is less than 5,000 EUR.
[47] Article 150 Companies Act.
[48] Article 144^1(5) Companies Act.
[49] The same standard is applied to the common law of agency by article 2018 of the New Civil Code.
[50] Article 2018 New Civil Code.

element of the directors' civil liability is not given when the conditions of the rule are met. In other words, it indicates the cases in which the director can avoid liability. The rule is meant to prevent judges from reviewing whether a business decision is useful, opportune or appropriate. It stems from the belief that the director, not the court, is best positioned to appreciate the benefits of an act or a business decision. The judiciary is only allowed to intervene in exceptional situations, as the first controlling body is the general meeting of shareholders.

The business judgment rule applies if three conditions are met: (a) the existence of a business decision taken within the powers (intra vires) conferred upon the directors; (b) the director was disinterested and acted in good faith,[51] and (c) he was adequately informed prior to taking the decision.

4.2.8 Duty to monitor

The duty of diligence and prudence is based on gathering information and monitoring the activity of the company. Thus, it includes the duty to monitor the company and especially the management. It is expressly provided for in the Companies Act, which refers to the duty of the directors to control and supervise the management. This constitutes the essence of the board's prerogatives, which cannot be delegated to executives.[52] Directors are liable for the damage caused by acts done by senior staff, if the damage would not have occurred had the directors exercised the supervisory duties imposed on them.[53] To enable effective control, the managers have the duty to inform the board of directors and to present periodical reports. The duty to monitor does not require the day-to-day supervision of management, but is to be understood as the more general task of being familiar with the internal operations of the company.

4.2.9 Duty of inquiry

The duty of inquiry is subsumed in the broader duty of diligence and prudence. Inquiry is one of the foundations of prudence. Under article 140^1 of the Companies Act, the chairman of the board has the fundamental obligation to monitor the good operation of all company bodies. The jurisprudence has stated that such expectations can only be satisfied by actively soliciting documents and information from executives.[54] In addition, the board fulfills the duty of inquiry through the work of consultative committees, which have the function of regularly forwarding to the board reports regarding their specific fields of the company's activities.[55].

4.2.10 Requirement of care in taking decisions

A last aspect of the duty of care is the requirement of care in decision-making. This duty comprises a procedural element consisting of carefully informing oneself before taking a decision. Thus inaction, passivity or unjustifiable absence from the board's meetings can attract liability for breach of the duty

[51] The benefit of the business judgment rule is not granted if the director has a personal interest in the decision.
[52] Article 142 par. (2) Companies Act.
[53] Article 142^2 par. (2) Companies Act.
[54] Cass.Com. July 2, 1985; Cass.Com. December 1, 1987, apud. Fr. Basdevant, A. Charv é riat, Fr. Monod, *Le guide juridique de l'administrateur de la société anonyme*, LexisNexis Litec, Paris, 2004, no.183.
[55] See articles 140^2 and 150^{10} Companies Act.

of care. The deliberation process, which represents the essence of the board's activities, has to be effective and consist of an exchange of opinions.

4.3 General conditions for liability

Because of the double nature of the liability of directors, contractual or tortious depending on the circumstances, there are a number of general conditions common to the two forms of liability, as follows:

- existence of an illicit action, consisting of a failure to comply with a contractual or statutory obligation which affects an individual right or an interest of the person injured;
- existence of a prejudice;
- existence of a causal link between the wrongful act and the damage caused by the director;
- fault or guilt of the director who committed the illegal act;
- no justification (e.g. creditor's fault, third party fault) for the unperformed contractual duty,[56] and no cause for exoneration of liability.

The director's liability is a subjective one, based on fault in the tradition of the French civil law. The director, as a remunerated organ of the company, is responsible for any form or degree of culpability, including *culpa levis*, i.e. imprudence or negligence of a small degree.[57] The standard of conduct is considered *in abstracto* by the courts.[58] Fault is determined in relation to the failure, delay or improper execution of obligations resulting from the articles of incorporation, the statute, or the agency/mandate agreement. In contractual obligations, fault is presumed until proven otherwise,[59] meaning that the burden of proof is on the debtor in case of non-performance. An exemption from liability arises in cases of force majeure, exceptional circumstances, fault of the victim or of a third party, as well as in case a person produces a prejudice through a non-abusive exercise of a right.[60]

4.4 Exemptions and limitations

The director can defend himself either by making his opposition to a business decision recorded in writing and informing the auditors about it, or by invoking the business judgment rule. The director's decision to take or not to take certain measures regarding the administration of the company is qualified by article 144^1 (3) as a business decision. Consequently, if a business decision was based on adequate information and exercised in good faith in the belief that the decision was in the company's interest, liability does not arise.

Furthermore, the company's articles of incorporation or the director's mandate agreement may contain clauses limiting the directors' civil liability. Such clauses must be in conformity with the conditions set forth in the civil law. According to articles 1170, 1203 and 1355 of the New Civil Code, Romanian law accepts and validates contractual clauses limiting the parties' responsibility, provided that the following public order conditions are met: (a) no party may waive their duty to act in good-faith; and (b) liability for intentional misconduct or gross negligence may not be excluded or limited in any manner. As a consequence, a breach of the duty of care and skill may be covered by the exclusion clause or ratified

[56] Article 1350 par. (2) New Civil Code.
[57] Article 1547 New Civil Code.
[58] Article 1540 New Civil Code.
[59] Article 1548 New Civil Code.
[60] Article 1351-1353 New Civil Code.

by the shareholders, as long as it is generated by *culpa levis*. Under this principle, the connection between the duty of loyalty and the duty of diligence and prudence becomes essential: as long as the director's decision passes the test of fairness, i.e. as long as there is no breach of the duty of loyalty, a waiver for breaching the duty of diligence is acceptable. *Mutatis mutandis*, breaching the fundamental duty of loyalty is equivalent to a bad-faith presumption, which means that the director's liability may not be excluded or limited.

Finally, the articles of incorporation or the director's mandate may provide that the company shall indemnify the director for the costs of defending himself against a liability claim. This situation may also be covered by the director's liability insurance policy, which is usually the case in practice. Such a policy is mandatory for a valid nomination of the director.[61]

4.5 Consequences of liability

The directors are liable to the company for the damage effectively caused, for the loss of company profit and for the expenses reasonably made by the company with a view to limiting or avoiding the damage.[62] They shall also be liable for the damage caused by acts performed by senior members of staff if the damage would not have occurred had they exercised their duties of supervision properly. In the latter case the liability is subsidiary and jointly with the subordinated company officer.[63]

4.6 Insurance against civil liability

Starting from December 2006, the legislation makes it compulsory for directors of public limited companies to take out professional liability insurance.[64] Nevertheless, the common law of mandate and administration laid down in the New Civil Code provides that an administrator (director, manager) may obtain from the Court a waiver from such duty by invoking good, solid reasons.[65] Directors of limited liability companies can also take out insurance, but this is not compulsory.

Depending on the contract, the insurance may cover compensation to be paid by the director for damage caused and for loss of profit as a result of wrongful acts, errors or omissions committed unintentionally in the management of the company, or the improper fulfillment of contractual commitments. The amount of coverage depends on the contract. The insurance contract may provide for the payment of court fees made by the applicant if the director was held liable by a final court decision. The insurance only covers civil, but not criminal liability or fines imposed due to a contravention of legal obligations.

[61] Article 153^{12} par. (4) Companies Act
[62] Article 1531 New Civil Code.
[63] Article 144^{2} Companies Act.
[64] Article 153^{12} par. (4) Companies Act.
[65] Article 818 par. (2) New Civil Code.

5 Duties in the Vicinity of Insolvency

5.1 The meaning of 'vicinity of insolvency'

The insolvency procedure is prescribed by Law no. 85/2006 (hereinafter Insolvency Law) and contains special rules relating to the liability of members of the board of directors and the management of a company. A company is considered insolvent when it has insufficient liquid assets to pay its debts as they fall due. This is presumed to be the case if one or several debts were not paid within 90 days of their due date. In order for a creditor to file an insolvency petition, the value of the creditor's claims must amount to at least RON 45,000 (approximately EUR 10,500). In case of claims arising out of employment relations, the threshold is the equivalent of at least six average salaries, determined at national level. The debtor has the obligation to file for insolvency within 30 days after the company has become insolvent.

There is no provision in Romanian law or jurisprudence giving rise to special directors' duties in the vicinity of insolvency. In light of comparative law and jurisprudence, the doctrine argues that the concept of the "company's interest" should be modified during the vicinity of insolvency and redirected towards protecting the legitimate interests of the company creditors, rather than promoting the shareholders' interests as residual claimants.[66]

The legal regime in the vicinity of insolvency is mostly concerned with the so-called "suspect period" regulated by articles 79-80 of the Insolvency Law. Transactions concluded by the insolvent company in the period of 120 days to 3 years prior to the opening of the insolvency proceedings may be cancelled by the insolvency judge if they were fraudulent to creditors and the insolvent company's directors may be liable to the creditors if the conditions provided by article 138 of the Insolvency Act are met (see point 5.4. below).

5.2 Damages for wrongful trading

Upon the request of the judicial administrator or the liquidator, as well as the creditors' general meeting, the insolvency judge may rule that the supervising or managing bodies of the company (including the directors) may be held liable for part of the debtor's liabilities, if such persons: (i) have used the assets or the credit of the company for their own benefit or for the benefit of a third party; (ii) have performed commercial transactions to their own benefit, under the cover of the company; (iii) have decided, to their own benefit, on the continuation of an activity which led to the cessation of the company's payments; (iv) have caused the unlawful keeping of company books; (v) have unlawfully taken or concealed part of the company's assets or have fictitiously increased liabilities; (vi) have used unlawful means in order to delay the state of insolvency; or (vii) have made preferential payments to certain debtors within the last month prior to the cessation of payments. Furthermore, criminal liability

[66] R. N. Catană, M. Carabaș, *Particularități ale eficienței instituției răspunderii civile a administratorilor și directorilor societăților comerciale, în contextul globalizării dreptului societar,* [Peculiarities of directors' and managers' civil liability in the context of the globalization of corporte law], Revista Română de Drept al Afacerilor, vol. 9, 2010.

may arise if the company administrator/s refuse to make the documents required in the course of the insolvency proceedings available to the judicial administrator or liquidator or do not initiate insolvency proceedings within the legal time frame.[67] In practice, when faced with a liability claim in respect of the insolvent debtor's directors, the judge will separate such matters from the insolvency file and open new proceedings. Thus, irrespective of the outcome of the insolvency procedure, the director may be held responsible even after the dissolution of the insolvent company.

5.3 Protecting creditors

One of the principles of the Companies Act is that creditors do not have an action against the company directors if the company is not in financial difficulties. Only shareholders can bring an action against directors through a decision of the general meeting of shareholders or through a derivative action by shareholders owning at least 5% of the voting rights. Thus, creditors are limited to bringing an action against directors and managers during insolvency proceedings and following the provisions of the Insolvency Act.[68]

Under the Insolvency Act, creditors' interests are protected by the insolvency practitioner. The judicial administrator or the liquidator is entitled to file cancellation actions with the insolvency judge regarding any transaction concluded by the insolvent debtor that conflicted with the interest of creditors within a three-year period prior to the opening of insolvency proceedings. Under such circumstances, the judicial administrator or the liquidator may ask for the cancellation of deeds regarding the establishment or the transfer of the debtor's assets to third parties.[69]

The Insolvency Law stipulates the limits of the reversible transactions, taking into account only the operations that are detrimental to the company's assets, as follows: transactions performed during a three-year period prior to the opening of the insolvency procedure in which the value of the services performed by the debtor exceeds the received consideration; transactions involving the transfer of ownership for the payment of a previous debt, performed during a 120-day period prior to the opening of the proceedings, if the amount the creditor would obtain in case of bankruptcy of the debtor would be lower than the value of the asset transferred; free transfers of property during a three-year period prior to the opening of the insolvency procedure; and agreements concluded during the three-year period with the intention to remove assets from the reach of the creditors or to affect the creditors' rights in any manner whatsoever. Moreover, the judicial administrator or the liquidator may challenge any transaction concluded during the three-year period with a shareholder holding at least 20% of the share capital of the debtor, with a director of the debtor, with an affiliate company, or with a co-owner having as its object an asset of the company, provided that such transactions are detrimental to the creditors' interests. In case the insolvency judge resolves to cancel such transactions, the third parties shall return the transferred assets or the amount representing the value of the performed services.

[67] Article 143 of the Insolvency Law provides that the debtor must file for insolvency proceedings within 6 months from the date that the company is found in a "visible insolvency", which is deemed to be the case 30 days after it has been ascertained that the company is unable to pay a debt, see article 27 of the Insolvency Law.
[68] Articles 73 par. (2) Companies Act.
[69] Articles 79, 80 Insolvency Law.

6 ENFORCEMENT OF DUTIES

6.1 Standing to sue

6.1.1 The company as plaintiff

The action to enforce directors' liability is a company action (*actio pro socio*); it derives from the shareholders' prerogative as owners of the whole entity. Accordingly, a corporate – not personal – prejudice must be shown.

The main enforcement mechanism is the action for damages vested in the general meeting of shareholders (article 155 of the Companies Act). Usually the decision to bring a lawsuit is taken when the general meeting votes on the annual financial statements. It can pass a resolution regarding the instigation of legal proceedings even if that point is not on the meeting's agenda. If the general meeting of shareholders decides to instigate legal proceedings it shall designate the person responsible to represent the company in court. At this point the defendant director's mandate ceases by operation of law and he needs to be replaced.

Despite the procedural deficits that characterise this action, the balance of power in the company is maintained. The action for damages against directors of a solvent company is rarely applied in practice, which is one of the reasons why the business judgment rule has not yet been discussed in published jurisprudence. Liability is usually alleged by company creditors in insolvency proceedings. One explanation for this phenomenon is the fact that outside insolvency shareholders are cautious to engage the liability of the directors, who are better informed and in a better position to steer the business of the company.

6.1.2 The shareholders as plaintiff

The efficiency of the action *ut universi*, described above, is compromised when the members of the board of directors are also shareholders, as their influence on the majority may have a deterrent effect on the shareholders.

This risk is mitigated by the existence of an individual action, *ut singuli*, as a last resort in the case of refusal by the general meeting to bring an action for damages. The right to bring an action in spite of the number of shares owned was transformed by Law no. 441/2006 into a collective action to be exercised by the shareholders. The action can be brought only by shareholders holding individually or jointly 5% of the share capital – if the articles of association do not provide for a lower threshold.[70] The minority shareholders act in their own name, but on the account (for the benefit) of the company. Damages ordered by the court have to be paid by the directors directly to the company. This type of action is subsidiary to the action *ut universi* exercised by the general meeting. It is conditional upon the refusal of the simple majority of shareholders to bring the action *ut universi*. Nevertheless, the

[70] Article 155^1 Companies Act.

claimant shareholders have to bear the costs of the proceedings, which has led to a low number of lawsuits in which the action *ut singuli* was exercised.[71]

6.1.3 Creditors suing

Creditors may exercise the action for damages only when the company is in insolvency proceedings. This type of actions has been discussed above in paragraph 5.4.

6.2 Criminal and administrative sanctions

Directors are criminally liable if their actions constitute offences under the Criminal Code or criminal provisions of special laws. The Companies Act lays down in Title VIII (articles 271-275) the infringements that are considered criminal offences, which are punishable with imprisonment if the directors do not comply with the requirements of the law. These crimes include among others the use of company assets in bad faith contrary to the company's interests or for personal use, spreading false news or using fraudulent means in order to gain an advantage at the expense of the company, or receiving and paying dividends out of fictitious profits based on a false balance sheet. Criminal proceedings against the director are brought by the prosecutor under the Criminal Procedure Code. The loss can be recovered by the company through the exercise of liability claims in criminal proceedings; the company constituting itself as a civil party. The law also classifies the cases that are contraventions.[72] In addition, the Securities Law indicates some contraventions[73] and provides for criminal sanctions.[74] Although the legal framework contains many sanctions that may be applied to directors, in practice, there have been only a few cases where members of the board have been sanctioned, although directors do not always comply with the law.

In case of a legal person acting as a director, the individual who is its permanent representative has the same civil and criminal liability as a director of the company.

[71] These costs shall be borne by the company in case the action is successful, article 155^1 par. (1) Companies Act.
[72] Article 270^3 Companies Act.
[73] Article 272 Securities Law.
[74] Article 279 Securities Law.

7 CONFLICTS OF LAWS

7.1 Classification under Romania's private international law

Law no. 105/1992, article 3, provides that if the determination of the applicable law depends on the classification of a legal institute or relationship then the classification made by the Romanian law applies.[75] In addition, qualifying a problem of law as procedural or substantive is made according to the *lex fori*, Romanian law.

7.2 Application of the relevant private international law rule

7.2.1 Company law

Law no. 105/1992 on private international law applies to civil, commercial, labor, civil procedure and other private law relationships with cross-border elements. The law stipulates that the incorporation theory applies in order to identify the corporate law applicable to a company. Accordingly, article 48 of Law 105/1992 provides that a company is governed by the law of the country where it was established. If a company is established in more than one country, the law of the place where the controlling body is located applies.

7.2.2 Tort law and contract law

Also relevant for the present report is the law applicable to contracts and tort. The law allows parties to choose the applicable law. In the absence of a decision the contract will be subject to the law of the state with which it has the closest connection. It is considered that such links exist with the law of the state where the debtor has its domicile or residence or head offices.[76] In the case of tort, the law of the place where the illicit act took place is applicable.[77]

7.2.3 Special duties in the vicinity of insolvency

Law no. 637/2002 regulates private international law in relation to insolvency (hereinafter Transnational Insolvency Law) and has implemented the Insolvency Regulation.[78] The law that applies to insolvency proceedings is the place where the center of main economic interest (COMI) is located. The transnational insolvency law applies in the following situations: if assistance is requested in Romania by a foreign court or by a foreign representative in connection with foreign insolvency proceedings; if assistance is requested in a foreign country in connection with a procedure carried out according to Romanian insolvency law; in case of holding Romanian insolvency proceedings and

[75] This conflict of laws norm is also stated in article 2558 of the New Civil Code, which, in Book VII, modifies Law no.105/1992 regarding the regulation of private international law relationships.
[76] Article 77 Law no. 105/1992.
[77] Article 107 Law no. 105/1992.
[78] Reg. (EC) No 1346/2000.

foreign insolvency proceedings regarding the same debtor; and if the creditors or other interested persons in a foreign country intend to request the opening of insolvency proceedings under Romanian Law.[79]

In order to recognise a procedure that was started in another jurisdiction transnational insolvency law will apply. This law is structured in two titles. The first title represents the enactment of the UNCITRAL Model Law on Cross-Border Insolvency, applicable to relationships with all foreign states, except the Member States of the European Union. According to this title, a representative of foreign proceedings has legal capacity in order to apply to the Romanian courts for recognition of the proceedings in which he has been appointed. The foreign representative must provide a statement regarding all foreign proceedings opened as to his knowledge against the debtor. The court needs to be aware of all other foreign proceedings in order to render the recognition decision and, particularly, for any type of relief that has been requested. The court may resolve to recognise the foreign proceedings only if the summoning procedure is legally fulfilled. The recognition comprises mandatory relief measures and triggers an automatic stay. However, in those situations where the recognition of a foreign procedure would run counter to Romanian principles of public order, the petition for recognition may be dismissed.

The second title of the law transposes European Council Regulation No. 1346/2000 on insolvency proceedings and applies to relationships with the EU Member States. The basic principle underlying the Regulation is that any court resolution for the commencement of insolvency proceedings rendered by the competent court of an EU Member State is directly recognised in all other Member States if the resolution becomes effective in the State where it was rendered. Court rulings opening insolvency proceedings in an EU Member State produce the same effects in all other Member States as under the law of the state of commencement, without the necessity to satisfy any formalities.

[79] Article 2 Transnational Insolvency Law.

LSE Enterprise

DIRECTORS' DUTIES AND LIABILITY IN SLOVAKIA

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CONTENTS

1 INTRODUCTION

1.1 Scope

This report analyses the duties, liability and responsibilities of members of the board of directors of public and private joint stock companies under the law of the Slovak Republic. For the purpose of this report, the members of the board of directors are called "directors". Although Slovak terminology provides that directors (*riaditelia*) may also be viewed as managers without the status of the statutory body authorised to act on behalf of the company, such persons are not the object of this report.

For the purposes of this report, director/s means the member/s of the board of directors which is a statutory body of a joint stock company entitled to act on behalf of the company (separately or jointly, as results from the internal company documentation). Such persons are registered in the Commercial Register. Directors are usually elected by shareholders at the company's general meeting, although the Articles of Association may stipulate that directors can be elected by the Supervisory Board.

Company: the Slovak law uses the term "commercial company", but for the purpose of this report, the term "company/companies" will be used.

1.2 Corporate law and directors' duties in Slovakia

The framework of Slovak corporate law was established during the 19th century in the Austrian-Hungarian Empire and, later, in Czechoslovakia. Therefore, the Slovak law is based on Roman law, and is also influenced by Czech and German and Austrian law. Two years after the social changes of 1989, Czechoslovakia introduced Act No. 513/1991 Coll. Commercial Code (**Commercial Code**) to regulate ownership and businesses. To this day, Czech jurisdiction and jurisprudence are still accepted in Slovakia, despite significant legal differences starting to emerge within the two countries.[1] Even though the possibility of re-codifying the civil law in Slovakia has been discussed for years, its corporate law is still regulated by the Commercial Code.

1.2.1 Legal sources of directors' duties

There is no exhaustive list of directors' duties in the Slovak legal system. The duties are regulated in various acts. The general relationship between the company as a legal entity and its statutory body is stipulated by Act No. 40/1964 Coll. Civil Code, as amended (the **Civil Code**). Section 20 of the Civil Code stipulates that a statutory body is acting on behalf of a legal entity. However, the Civil Code does not regulate particular duties and liability. The legal framework of directors' duties is established by the **Commercial Code** which provides the most important duties and liability of directors (for more detailed analysis of the relation between the Civil Code and Commercial Code, please see below).

[1] The most important change and interruption of the joint development is given by a recodification of the Czech civil law, especially by adopting the new Civil Code.

Specialised directors' duties and liability are stipulated by a variety of Acts, especially in the field of financial services, such as:

Act No. 7/2005 on Bankruptcy and Restructuring, as amended (the "Act on Bankruptcy")

Act No.566/2001, Coll. on Securities and Investment Services, as amended (the "Act on Securities")

Act No. 483/2001 Coll. on Banks, as amended (the "Act on Banks")

Act No. 203/2011 Coll. on Collective Investment, as amended (the "Act on Collective Investment")

Act No. 43/2004 Coll. On Retirement Pension Saving, as amended (the "Pension Act")

In the field of public law, the most important laws are established by Act No. 300/2005 Coll., the Criminal Code, as amended (the "Criminal Code") and Act No. 747/2004 Coll. on Supervision of the Financial Market, as amended (the "Act on Supervision").

State-controlled companies that have the status of a joint stock company are governed by the same rules in respect of directors' duties and liability. These rules are outlined in the special regulations of the state enterprise (Act No. 111/1990 Coll. on State Enterprise, as amended) and legal entities administrating the state assets (Act No. 278/1993 Coll. on Administration of the State Assets). However, state-controlled companies are not the subject of this report.

The legal relationship which comes closest to an English law trust is regulated in the Mandate Agreement[2] (section 566 – 576 of the Commercial Code). Provisions governing this Agreement also apply to the members of a statutory body and the company, if an agreement on performance of function is not satisfied[3]. If an agreement on performance of the function is satisfied, it is regulated under the Commercial Code and matters not directly stipulated in the agreement are governed by the Mandate Agreement accordingly. ection 194(8) of the Commercial Code provides that "Agreements between the company and a member of the board of directors that exclude or limit the liability of the member of the board of directors are prohibited" (this section will be discussed in greater detail below). Therefore, even the Commercial Code does not stipulate any requirements for the Agreement of Performance of Function, the Agreement must nonetheless not breach the binding provisions of law.

The concept of proportionality is not discussed directly in the law. However, proportionality is considered as a matter of general application by the court when deciding a particular case and considering a particular situation. Proportionality is one of the leading principles of law.[4]

[2] Mandate Agreement: Section 566 of the Commercial Code: (1) Under a mandate agreement, the mandatary undertakes to arrange a certain business matter for the mandator, at the mandator's expense and for a consideration, by undertaking legal acts in the mandator's name or by conducting other activity, and the mandator undertakes to pay them a consideration in return. (2) If the mandatary's entrepreneurial activity includes arranging such matters, it shall be deemed that the consideration has been agreed.
Section 567 of the Commercial Code: (1) "The mandatary is obliged to proceed with professional care when arranging the matter."

[3] Section 66(3) of the Commercial Code: "The relationship between the company and a member of the company body or a shareholder/member involved in arranging the company's affairs shall be subject, as appropriate, to the provisions on mandate agreements, unless the rights and obligations are stipulated otherwise by law or by an agreement on performance of an office concluded between the company and the member of the company body or the shareholder/member if such an agreement on performance of an office was entered into. An agreement on performance of an office must be in writing and must be approved by the company's general meeting or in writing by all the shareholders/members who hold unlimited liability for the company's obligations. The articles of association of a joint stock company may stipulate that an agreement on performance of the office of a member of the board of directors shall be approved by the supervisory board."

[4] Barány, 2007, p. 152.

1.2.2 Regulation of the Directors' Duties in General Private Law

Generally, relations that are comprehensively established by the Commercial Code are not regulated by the provisions of the Civil Code. Duties and liability of directors are comprehensively regulated by commercial law; therefore general civil law does not apply. However, the Civil Code is used when the regulation in the Commercial Code is not comprehensive or when a certain phenomenon or an aspect thereof is not regulated by the Commercial Code.

Private law (especially the Civil Code) regulates the general relationship between a legal entity and its statutory body. Particular duties and liability of directors are governed by the Commercial Code and several special acts (as discussed above).

Under section 1(1) of the Commercial Code, the Commercial Code regulates the status of entrepreneurs, commercial obligations and some other relations relating to entrepreneurial activity. Under section 1(2) of the Commercial Code, the legal relations specified in Subsection 1 above are regulated by the provisions of the Commercial Code. Should it prove impossible to resolve certain issues according to the provisions of the Commercial Code, such issues shall be resolved in accordance with the civil law. Should it prove impossible to resolve such issues in accordance with the civil law provisions, those issues shall be according to commercial practice and, in the absence of commercial practice, the principles upon which the Commercial Code is based.

The application of commercial law and civil law respectively would in some aspects produce different results. Importantly, liability under civil law is based on different principles to commercial law liability. The liability under the civil law regulates relations between non-entrepreneurs. Fault (*culpa*) is necessary for liability under civil, but not commercial, law. The liability under commercial law is objective, regardless of fault. For recovery of damage, a *causal nexus* between the breach of obligation and the existence of damage is needed. Liability in an administrative procedure (mainly imposing sanctions by the National Bank of Slovakia as a supervisory body in financial sector) requires a fault. Also the duty of care is stricter under the commercial law, as it is regulating the actions of professional entrepreneurs who have relevant skills and knowledge.

Some relations of entrepreneurs are regulated exclusively by civil law, as the regulation in the Commercial law is missing. This is the case, for instance, when an entrepreneur leases or transfers real estate (the only exception is the transfer of real estate as a part of the sale of an enterprise, which is regulated by the Commercial Code). Another example is provision of good morals stipulated only in the Civil Code (not in the Commercial Code). Based on section 1 of the Commercial Code, provisions of the Civil Code regarding good morals can apply in business relations. Nevertheless, in practice reference to good morals is used very rarely by the Slovak courts in matters concerning relations of entrepreneurs.

As discussed above, some fields of law are regulated by the Commercial Code only partially. In such instances, the general civil law will be applied to fill in the gaps of the Commercial Code (or special acts). Examples include miscellaneous provisions on legal acts (section 266 – 268 of the Commercial Code); miscellaneous provisions on concluding contracts (section 269 – 288 of the Commercial Code); miscellaneous provisions on contractual penalties (section 300 - 302 of the Commercial Code); miscellaneous provisions on expiry of unfulfilled obligations (section 344 - 357 of the Commercial Code), etc.

Directors' duties and liability are regulated comprehensively by the Commercial Code (including the recovery of damage under section 373 of the Commercial Code). Based on the above, the liability of directors will be determined by the Commercial Code regulations. This allows for the possibility to apply principles of good morals on directors' duties and liability, but in a limited scope (due to the strict and narrow approach taken by the courts).

It should be noted pro futuro that there are yearly attempts to re-codify the Civil Code and the Commercial Code. The result would be a joint Civil Code regulating the obligations of entrepreneurs and a separate Company Act regulating company law. The existing Commercial Code would be repealed. These suggested changes have recently been approved by the Czech Republic legislature. Obviously, certain areas of the directors' duties and liability would remain c covered by the public law (especially the Criminal Code and the Act on Bankruptcy).

1.2.3 Directors' duties defined in statute

The general directors' duties are mostly established in sections 191 – 196s of the Commercial Code (see footnotes 13 to 15). Further duties are specified by special acts, particularly in the financial sector (e.g. Act on Banks, Act on Securities, etc.).

Before 2002, the level of legislative specificity was low. The Commercial Code stipulated just basic duties and due care without providing further direction on how those concepts were to be applied. Since 2002[5], the duties and due care are defined with greater precision. However, the legislation maintains a broad definition of due care. Due to the fact that the Slovak courts interpret the law very restrictively, we believe that the greater degree of specification benefits stakeholders.

1.2.4 The Role of the Courts in Shaping Directors' Duties

In principle, all the directors' duties and liability are established by Acts. The Slovak law does not recognise case law as a source of law. Therefore, a decision made by one court will not bind another court. However, case law provides a persuasive precedent, with the decisions of superior courts generally being considered more relevant. Due to a joint history with the Czech Republic, the decisions of Czech courts may also be considered if the relevant legislation interpreted by the court is similar to a Slovak law.

Nevertheless, it is not unusual if the courts (including the Supreme Court) interpret the same law differently. The court is bound just by the written law or contracts based on the written law, not by decisions of higher courts.

Generally, there are very few court decisions regarding the breach of duties and liability by directors of public companies. Despite the fact that there were many cases that alleged illegal asset stripping, especially throughout the 1990s up to the present, in the vast majority of cases such allegations were not proved. To a certain extent, this has been caused by the prosecution and courts applying the law in a very narrow way. Usually, the courts declared that a breach of duties has not been proved. The failure of the courts to find a breach of directors' duties has continued even after the Commercial Code was amended in 2002 to specify

[5] The Amendment No. 500/2001 Coll. has been adopted in connection with appoximation of the law with the regulation of the European Union.

directors' duties more precisely – an amendment which coincided with the accession of the Slovak Republic to the EU. [6] One of the finalised criminal procedures of asset stripping/defrauding investment funds resulted in the conviction of Vladimír Fruni, the executive director of BMG INVEST, s.r.o. (it was a limited liability company that went bankrupt in 2002) and the chairman of the board of directors of Horizont Slovakia, a.s., which went bankrupt in 2002.[7] He was sentenced in 2002 to an 11.5 year term prison sentence for the fraud which saw approximately 120 000 mainly small investors lose around half a million Euros in principal. After nine years imprisonment he was released for good behaviour.

There has been some case law that has impacted on directors' duties. In addition to the two judgements of the Supreme Court of the Slovak Republic referred to in the chapter on director liability, there is another relevant case. In judgement no. 4 Obo 125/2003 the Supreme Court ruled that a scenario where a contribution of SKK 91.5 million (approximately EUR 3 million) corresponds to a shareholding interest of merely 16.67%, whereas the contribution of another shareholder in the amount of SKK 100,000 (approximately EUR 3,300) corresponds to a contribution of 83.33%, is null and void due to contradiction with the principle of good morals. The judgement shows that even in limited liability companies where the shareholders are free to determine the proportion of shareholding interests irrespective of the proportion of contributions, such determinations must be compliant with certain general principles of Slovak law, including the principle of good morals. By extension, it could be argued that if a director is to comply with the duty of due care, he or she must consider both specific laws and general principles of law.

1.2.5 Market Practice and Assessment of Director Conduct

The role of market practices is influenced by the Slovak economy, market, and a relatively small number of public companies. A high number of Slovak companies are owned by foreign shareholders. Most Slovak companies are private. After privatisation was carried out after 1989, foreign shareholders often engaged foreign directors who had contracts with parent companies. Certain formal legal relations had been established under the Slovak Commercial Code, but a legal relationship also existed with the parent companies. At present, more Slovak directors than foreign directors are engaged by Slovak companies. Nevertheless, based on the information we have, there is still a strong influence of foreign shareholders on market practice when assessing director conduct.

For further details, please refer to the section dealing with the limitation of liability of directors (both ex-ante and ex-post).

1.2.6 Sectoral Requirements

Specific rules apply to the financial sector, such as duties of members of the board of directors of a stock exchange, security dealer and pension funds. The National Bank of Slovakia (the central bank) is the public institution charged with the supervision of such companies. These rules are established by special acts. Moreover, there is a Corporate Governance Code for companies listed on the Bratislava Stock Exchange (please see also Chapter 3.4. above).

[6] According to informal information we have, the criminal procedures connected with bankruptcies of several banks (e.g. Devín banka (bankruptcy in 2001), Slovenská kreditná banka (bankruptcy in 2000), have still not been concluded.
[7] Other members of boards of directors/executive directors have also been convicted and sentenced to prison sentences, for instance, entrepreneur Jozef Majský who has been sentenced to 12 years imprisonment by the Specialised Criminal Court. However, his case has not been closed to this day. WHAT DOES THIS LAST SENTENCE MEAN?

Other sectors are not subject to special regulations. Some sectors (within sector associations) have "Ethical Codes",[8] which are not legally binding. Ethical codes do not usually state directors' duties or liability, but rather impose obligations on the company to behave in a certain way towards competitors and clients. As discussed above, internal rules are often stipulated by particular foreign shareholders (parent companies).

1.3 Corporate landscape in Slovakia

Based on section 56(1) of the Commercial Code, The Slovak law recognises the following four types of companies:

Type of company	Regulatory framework	Ownership structure	Basic description
Unlimited company (partnership) (*verejná obchodná spoločnosť*, abbreviation *ver.obch.spol.* or *v.o.s.*)	Sections 76 – 92 of the Commercial Code	Private	A company in which at least two persons conduct entrepreneurial activity under their common business name and hold joint and several liability for the company's obligations with their entire property.
Limited partnership (*komanditná spoločnosť,* abbreviation *kom.spol.* or *k.s.*)	Sections 93 – 104 of the Commercial Code	Private	A partnership in which one or more members are liable for the partnership's obligations up to the amount of the unpaid parts of their investment contributions as entered in the Commercial Register (limited partners), and one or more members are liable for the partnership's obligations with their entire property (general partners).
Limited liability company (*spoločnosť s ručením obmedzeným*, abbreviation *spol. s r.o.* or *s.r.o.*)	Sections 105 – 153 of the Commercial Code	Private	Company whose registered capital is made up of its shareholders' previously determined investment contributions. A limited liability company can have no more than 50 shareholders. Each shareholder is liable for the company's obligations up to the amount of the unpaid proportion of his or her investment contribution entered in the Commercial Register. The executive director is the statutory body elected by the general meeting. A supervisory

[8] Ethical Code of Insurance Companies http://www.slaspo.sk/tmp/asset_cache/link/0000021971/Kodex%20etiky%20v%20poistovnictve%202009.pdf (in Slovak language only) or Code of Member of Association of Asset Management Companies: Rule 11 Member of the Association must not behave in unprofessional way containing unfairness, fraud or purpose manipulation with facts or participate in such behaviour. http://www.ass.sk/Default.aspx?CatID=44# (in Slovak language only)

			board is not compulsory (but may be established) and does not have any managerial powers.
Joint stock company (*akciová spoločnosť*, abbreviation *akc. spol*. or *a.s*.)	Sections 154 – 220a of the Commercial Code	Private or public	A company whose registered capital is distributed into a certain number of shares with a certain nominal value. The company is liable for breaches of its obligations with its entire property. A shareholder is not liable for the company's liability. If all or some of a company's shares have been accepted for trading on a regulated market situated on or operated in any of the State Parties to the Agreement on the European Economic Area, it will be deemed to be a *public joint stock company*. At its general meeting, a public joint stock company may decide, with the consent of a two-third majority vote of shareholders present, to stop trading its shares on the regulated market and to become a *private joint stock company*. The decision that the company stops trading its shares on the regulated market must be recorded in the Collection of Documents and the company is obliged to publish a notice of its adoption of such decision in a national periodical publishing exchange report. If, after the adoption of such decision, an exchange accepts the company's shares for trading on the regulated market, the company again becomes a public joint stock company. The provisions of this Subsection shall not affect the obligations under special regulations regulating securities and regulated markets that relate to changing a public joint stock company to a private joint stock company or that relate to a company stopping trading its shares on the regulated market. A public call to subscribe shares is a public offer of securities under a special regulation (Act on Securities).

Based on the Slovak law, a cooperative (*družstvo*) is not considered to be a company and it is regulated by the Commercial Code (ections 221 – 260 of the Commercial Code). Moreover, there are European legal forms of companies that are regulated by special acts based on principles given by the relevant EU directives. Associations regulated by the Civil Code may exist in form with legal capacity or without legal capacity and, despite being entitled to perform business activities, are not considered to be business companies and are not registered in the Commercial Register.

In terms of joint stock companies, there are no differences between public and private companies (or listed or non-listed companies). It should be noted that the Slovak law provides for public and private joint stock companies. Public companies are regulated by section 154(3) of the Commercial Code. A joint stock company may be a private joint stock company or a public joint stock company. If all or some of a company's shares have been accepted for trading on a regulated market situated or operated in any of the State Parties to the Agreement on the European Economic Area, that company is deemed to be a public joint stock company. There are a limited number of public joint stock companies in the Slovak Republic. Other types of companies (private joint stock companies; limited liability companies; unlimited companies; and limited partnerships) prevail. Our analysis covers both the public and private joint stock companies (listed and non-listed).

The directors' duties of companies listed at The Bratislava Stock Exchange are regulated by the Corporate Governance Code. From 1 January 2008, the Code has applied to all companies whose securities have been admitted to trading on the Bratislava Stock Exchange's regulated market, that is, the main listed market, the parallel listed market and the regulated free market.[9]

[9] The Code is published at: http://www.bsse.sk/bcpben/IssuersGuide/CorporateGovernance/tabid/965/language/en-US/Default.aspx

2 THE CONCEPT OF 'COMPANY DIRECTOR' IN SLOVAKIA

2.1 De iure directors

2.1.1 Requirements to become a de iure director

Regarding the appointment and recall of directors, under section 194(1) of the Commercial Code, members of the board of directors are elected and recalled by the general meeting from the shareholders or other persons for a period determined in the articles of association, which must not exceed five years. The articles of association may determine that members of the board of directors are elected and removed by the supervisory board in the manner stated therein. Under section 194(2) of the Commercial Code, the body that elects members of the board of directors shall also determine which members of the board of directors is its chairperson. If members of the board of directors are elected by the supervisory board, the persons elected as the first members of the supervisory board shall elect the first members of the board of directors before the application for registration of the company in the Commercial Register[10] is filed. The provision of section 194(1) shall apply accordingly to the decision-making of the first members of the supervisory board.

Members of the board of directors must be registered in the public Commercial Register. However, the duties of directors begin to apply on the day of election (if not stated a later day). The registration in the Commercial Register has a merely declaratory character.

2.1.2 Who can be *de iure* director

Based on section 194(2) of the Commercial Code, a member of the board of directors must be a natural person. Such person must have full legal capacity and be at least 18 years of age. Based on requirements on performance of function stipulated by law, such a person must be able to perform his or her functions with due care. However, whether the person possesses the ability to perform his or functions with due care need not be established in advance of that person's appointment, and does not have to be proved for the purpose of election or registration of the director in the Commercial Register.

2.2 De facto and shadow directors

The Slovak law does not recognise the concept of a "shadow director" or a "de facto director". Only a formally appointed person (as will be discussed below) is considered to be a director with all the attendant rights and obligations. The status of other persons that perform certain managerial and director-like tasks but who have not been formally appointed and registered will be that of employees or contractors, depending on whether their relationship with the company is governed by an employment contract or contract under commercial law.

[10] The Commercial Register is the public register of all corporate entities existing under Slovak law (the law specifically sets out which legal persons and other entrepreneurs are obliged to register themselves in the Commercial Register). Associated to the Commercial Registry is the Collection of Deeds, which collects certain relevant corporate and financial documents of the entities registered with the Commercial Registry. The law that regulates both the Commercial Registry and the Collection of Deeds is Act No. 530/2003 Coll. on the Commercial Register, as amended (the **Commercial Register Act**).

For the sake of completeness, please note that terminologically, certain managerial positions in Slovak companies are translated into English as “directors” (for example, Director of Sales, Director of Procurement, Financial Director, Commercial Director), however, the use of this term does not grant those holding managerial positions any specific rights or obligations unless they have been formally appointed.

3 THE SCOPE OF DIRECTORS' DUTIES UNDER SLOVAKIAN LAW

3.1 Types of directors' duties

3.11 The nature, content and extent of duties

section 194(5) of the Commercial Code provides that:

Members of the board of directors are obliged to execute their powers with due care, which includes the obligation to exercise their powers with professional care and in accordance with the interests of the company and all of its shareholders. In particular, they are obliged to obtain and take into account in their decision-making all available information relating to the subject of their decision, to keep in confidence confidential information and facts whose disclosure to third parties could cause harm to the company or endanger its interests or the interests of the company's shareholders, and while exercising their powers, must not give priority to their own interests, the interests of only certain shareholders or the interests of third parties over the company's interests. Generally, the standard of care is an objective standard.

Before 1 January 2002, the duties of members of the board of directors were not specified. Accordingly, only provisions of the mandate agreement applied, which stated that professional care must be taken. Due to missing experiences and longer development, the courts were not able to apply these provisions. Because it is difficult for courts to determine whether professional care has been taken, courts tend to find in favour of directors.

3.1.2 The legal grounds of directors' duties

Directors' duties are stipulated primarily in the Commercial Code, secondarily in special acts governing special fields of business activities. The Slovak law does not recognise case law as a source of law. The courts strictly interpret legislation.

Basic duties are expressed in the following acts:

Proper care duty (stipulated in section 194(5) of the Commercial Code)

Loyalty duty (stipulated in section 194(5) of the Commercial Code)

Duty to act in good will (stipulated in section 194(7) of the Commercial Code)

Compensation for damage duty (stipulated in section 194(6) of the Commercial Code)

Risk management duty (stipulated in special acts, for example, in section 34(2) letter c) of the Act on Stock Exchange as a duty to recognise and declare a risk in the financial statement; and to control the risk and ensure the safety and soundness of the bank as found in section 24 of the Act on Banks. Generally, the risk management duty can be deducted also from obligations stipulated by the Act on Bankruptcy, such as section 4 – prevention of bankruptcy. The risk management duty is also established by the Corporate Governance Code used by The Bratislava Stock Exchange (please refer to question 1.3 for further information)).

The directors' duties are of an objective nature (breach of the duty, occurrence of damage and *causal nexus* must be proved, and no fault element is required). The statutory body has to prove that cumulatively it fulfilled at the same time its duties of proper care and acted with good will. In case it proves the fulfilling of these requirements the liability of the statutory body does not occur even if its decision was generally incorrect.[11]

The directors' duties arise on the day that the person has been elected as director or on a later date stipulated in the decision of the General Meeting or the Supervisory Board. The registration in the Commercial Register merely has a declaratory character. Directors' duties cease to exist on the day the director is recalled/ resigns from the function. [12] However, some duties, such as the duty to keep confidential information private and to recover damages, do not cease[13].

The relationship is similar to a fiduciary relationship and is regulated based on the agreement of performance of function or mandate agreement accordingly. However, the substance of the relationship is in the act, not in contract. At the same time, the bases of the directors' duties and liability are stipulated by acts, and may override the agreement and internal rules of the company. The Slovak Republic applies the German approach of preferring the more precisely defined rules in acts to internal company documents in deciding what should govern the relationship.

The most important directors' duties are stipulated in sections 191 – 196a of the Commercial Code (see Annex 1)[14]. A member of the board of directors must comply with any single duty set by the law or articles of association or internal rules. There are no direct priorities for what a director must comply with. However, the law stresses the importance of avoiding certain breaches leading to liability for damage in section 196 (6) of the Commercial Code (see Annex No. 1 hereto). Obviously, the court would evaluate particular activities and measure them in the context of the factual situation as a whole.

To evidence the fulfilment of duties is mainly a responsibility of the supervisory board or of another supervisory body (internal departments, external or internal auditors, etc.). Special acts that mainly regulate the financial sector stipulate the special duties of supervisory bodies.

Non-compliance with a duty might be allowed by the general meeting if the relevant duty is not stipulated by an act, and merely results just from the internal rules of the company. We believe the general meeting cannot approve a breach of the articles of association. Rather, the articles of association must be amended.

In practice, it is quite usual for the board of directors to ask the general meeting for approval of certain activities. Under section 194 (7) of the Commercial Code, members of the board of directors shall bear no liability for any damage caused to the company by their conduct in executing a decision of the general meeting. However, Section 194 (7) does not apply if the general meeting's decision is contrary to legal

[11] Duračinská, 2010, page 49

[12] Under section 50(2) of the Act on Banks, the bank must recall a person who became untrustworthily due to the fact that the National Bank of Slovakia imposed his/her a financial sanction for breaching his/her duties specified in the Act on Banks or other generally binding legal provisions.

[13] Based on sections 397 and 398 of the Commercial Code, the period for limitation of the right to recovery the damage is 4 years from the from the day when the damaged party learned or could have learned of the damage and of the party that is obliged to compensate the damage; however, it ends at the latest upon the lapse of 10 years from the day when the obligation was breached.

[14] There are more particular duties in the Commercial Code, e.g. prohibition of agreements on voting with the shareholders (section 186a of the Commercial Code), preparation of the minutes from the general meeting (section 189 of the Commercial Code); however, we believe the most important principles are explained in the analysis.

regulations or the company's articles of association. Members of the board of directors are not relieved of liability if their conduct was approved by the supervisory board.

Conflicting duties are regulated by Sections 59a, 194 (7, 8, 9), Section 196 (non-compete clause) and Section 196a (granting loan, credit, property to members of the board of directors).

3.1.3 Specific aspects of the directors' duties

When seeking to enforce directors' duties, it is important to note that if the duty is stipulated by law, there is no need to prove the existence of the duty (the principle *iura novit curia*). Also, if certain conditions are met, it is possible to ratify the breach.

The Slovak Commercial Code recognises both the duty of care and the duty of loyalty. However, these are not defined as major duties/types. Breaching of any duty can lead to the same basic consequences such as the recovery of damage and a contractual penalty.

3.1.4 Duties under special Acts

Some special Acts stipulate further sanctions for breaching duties. Importantly, such special acts may also contain different mechanisms for the establishment of a breach of duty. For example, the imposition of a penalty by the National Bank of Slovakia (or other supervisory body acting within administrative procedure) requires the finding of fault. Nevertheless, based on the informal information we have, no member of the board of directors of a bank were sanctioned by a personal penalty levied by the National Bank of Slovakia. Rather, the penalty is more likely to be imposed to a bank as a company.

Further examples of special acts that regulate duties and sanctions for the breach thereof are the Criminal Code, Act No. 431/2002 Coll. on Accounting, as amended, and tax laws, etc. (for further information, please see questions concerning criminal liability). As indicated in the preceding paragraph, the financial sector has a special regulatory framework (please see acts published in English language at http://www.nbs.sk/en/legislation/full-wordings-of-legal-regulations-within-the-nbs-competence).

3.2 To whom are the duties owed?

Duties are owed to the company and all of its shareholders. Generally, directors are responsible towards the shareholders. The relationship between directors and shareholders is also regulated by Section 182 of the Commercial Code (*actio pro socio*). The nature of the company does not play a material role in their relationship. In respect of the shareholder/stakeholder debate, the Slovak law represents the narrow approach, focussing on the shareholders. We are of the opinion that if the most important interest of the shareholder is to maximise profit, the interest of the company (avoiding activities that are too risky to avoid bankruptcy) should prevail. However, it could also be argued that the reason why a company exists is to generate profit for its shareholders. In Slovakia, this debate is more or less academic since we do not have sufficient published jurisprudence on this topic.

The Slovak duties do not allow directors to discriminate between different groups of shareholders or make determinations on how long-term and short-term interests can or should be reconciled.[15]

3.2.1 Interest of the company

The company is understood as a separate legal person with its own property. However, based on the last sentence of Section 194(5), it is possible to conclude that the law aims to provide the same level of protection to *all* shareholders.[16]

There are no significant differences in respect of justification of duties. Even though the term “company” may include also employees, for the purpose of duties of the directors, the Slovak law does not recognise a duty of loyalty towards employees.

3.2.2 Interests of creditors and employees

The joint stock company created for business purposes is properly understood as an entity for the production of profit. Although the interests of employees and creditors can be considered, in the event of a conflict, the interests of shareholders will prevail. In practice, situations often arise where the board of directors determines that employees must be dismissed. While such a decision is not in the interest of the employees, such a decision is in the interest of the company if it means that the company will therefore avoid bankruptcy. Dismissal of employees can also be in the interests of the creditors, although such a decision would be made to ensure that the company survives and that shareholders do not lose money or their investment.

3.2.3 Creditor’s interests

In principle, directors’ duties do not include protection of the interest of creditors. Creditors cannot compel directors to comply with their duties. However, creditors can initiate administrative procedures to seek to compel directors to comply with their duties. In the financial sector, for instance, this could be done by initiating proceedings through the supervisory body of the National Bank of Slovakia.

Under section 194(9) of the Commercial Code, the claims for damages that a company has against members of the board of directors may be exercised by a creditor of the company acting in his or her name and on his or her own account, if he or she is unable to satisfy his or her receivable from the company’s property. The provisions of subsection 6 through 8 apply accordingly. Claims of the company’s creditors against members of the board of directors shall not expire if the company waives claims for damages or concludes a settlement agreement with the creditors. If bankruptcy is declared against the company’s

[15] For an example where the discrimination of one group of shareholders was permissible see Gaiman v National Association for Mental Health [1970] 2 All ER 362.

[16] Section 194(5) of the Commercial Code: Members of the board of directors are obliged to execute their powers with due care, which includes the obligation to exercise their powers with professional care and in accordance with the interests of the company and all its shareholders. In particular, they are obliged to obtain and take into account in their decision-making all available information relating to the subject of their decision, to keep in confidence confidential information and facts whose disclosure to third parties could cause harm to the company or endanger its interests or the interests of the company’s shareholders, and while exercising their powers, must not give priority to their own interests, the interests of only certain shareholders or the interests of third parties over the company’s interests.

property, the claims of the company's creditors against members of the board of directors shall be exercised by the bankruptcy trustee.

3.3 The director as a shareholder

In respect of directors who are concurrently shareholders, the Slovak law does not have a special regulation. In principle, the shareholder may become a member of the board of directors and but this is very usual, especially in private joint stock companies. We are of the opinion that the shareholder may exercise his or her voting rights at the general meeting in his or her own self-interest, even if these interests are opposed to those of the company. However, once the natural person acts outside the general meeting, he or she should act in the interest of the company and all of its shareholders. Again, there is not sufficient published case law that would provide a conclusive answer to how this scenario would be resolved. Therefore, we can merely predict a court decision based on general principles.

In this respect, it is worth noting that the concept of Corporate Social Responsibility has been taking root in the Slovak subsidiaries and branches of multinational corporations.

The situation where a shareholder is represented at a general meeting by a power of attorney is not properly regulated at law. In a limited liability company, the Commercial Code prohibits a shareholder being represented by a statutory body such as an executive director (see section 126 of the Commercial Code). However, in a joint stock company, the Commercial Code prohibits the shareholder's representation only to members of the supervisory board, unless the Commercial Code states otherwise (see section 184(1) of the Commercial Code).[17] Based on the principle of equal treatment and duty of loyalty towards all shareholders, we believe a member of the board of directors must not be an authorised representative of one or more shareholders. In practice, it is usual that a majority shareholder elects a person that he or she thinks will promote his or her business interests to the board of directors. Very often, the person elected to the board of directors has pre-existing employment or business relations with the majority shareholders. Nevertheless, we are of the opinion that such representation at the general meeting is not allowed and that such a director would be in breach of his or her duty of loyalty.

3.5 Application of duties to de facto and shadow directors

On a separate note, while the concept of shadow directors is not recognised under Slovak law, it is possible to analyse the position of a **"**putative" director, that is, a person who pretends to be a director and act on behalf of the company. Normally, a prudent third party would only accept the acting on behalf of a company of a director who can evidence his or her authority by means of an extract from the Commercial Register. However, under Slovak law, the assumption of the role of a director is effective upon the appointment (provided that the director accepts such appointment), rather than the registration in the Commercial Register, unless the appointment resolution itself stipulates a later date. Thus, there is often a "gap" of a couple of days between the appointment of a director and his or her registration with the Commercial Registry.[18] Consequently, a situation could theoretically arise that a party is misled to believe that a certain person is a director who has been appointed, but not yet registered.

[17] The authorised representative of a shareholder may not be a member of the company's supervisory board, unless this Act stipulates otherwise.
[18] Under the law, the registration takes up to five business days as of the filing of an application with all necessary annexes.

Under section 27(5) of the Commercial Code a third party is entitled to rely on the content of documents that have not yet been registered with the Commercial Registry or the Collection of Deeds, unless the law stipulates that those documents can only become effective upon registration. Therefore, if a third party was presented, for example, with a (counterfeit) resolution of the general meeting of shareholders on the appointment of a person as the director, such a third party would be entitled to rely on the presented resolution. Because the putative director is not a director *lege artis*, his or her actions would not bind the company. However, the third party would be able to claim damages from the putative director for the damage caused by misleading. An exemption exists under section 15(2) of the Commercial Code, whereby if a person entrusted with performance of a certain activity in the operation of an enterprise is entitled to undertake all acts usually involved in the course of such activity and if the person exceeds the powers conferred on him or her, the entrepreneur shall only be bound by such conduct if the third party was not aware that the person had exceeded his or her powers and, in light of all the circumstances of the case, could not have been aware that the person had exceeded his or her powers. Depending on the circumstances, the putative director could be criminally liable for fraud.

4 LIABILITY FOR BREACH OF DUTY

4.1 Legal characterisation of the duties and liability

Directors' duties and liability can be of either statutory or contractual nature. In the case of statutory duties, these can be further divided into duties under company law, civil law, administrative law and criminal law.

Contractual duties can arise under the so-called agreement on the performance of an office (Management Agreement). This is a basic contractual document that regulates the relationship between the director and the company. In line with section 66(3) of the Commercial Code a Management Agreement must be in writing and must be approved by the company's general meeting or in writing by all the shareholders/members who hold unlimited liability for the company's obligations.

4.1.1 Branches of law regulating the duties and liability

Company law lays down a number of obligations of the board of directors. Such duties include: the duty to invite shareholders to general meetings; the duty to treat all shareholders equally; the duty to request payment from a shareholder who has not paid for his or her stock; the duty to exclude a shareholder who fails to pay the stock price despite such reminders; the duty to organise a general meeting that is compliant with legal conditions; and the duty to invite all shareholders to a general meeting. The breach of any of these duties would result in liability under the Commercial Code.

The Civil Code sets out the general framework for liability for damage caused under any private law regulations, unless those regulations specifically fall within the ambit of the Commercial Code. Therefore, the breach of a duty established by the Civil Code or other private law regulation would be determined under the Civil Code. This would include tortious liability.

Please note that liability under civil law is considered to be a fault-based liability. This can be deduced from section 420(3) of the Civil Code which establishes that a person who proves that she has not caused the damage will be relieved of liability. The burden of proof is on the defendant, provided that the principal tenets of the liability for damage have been proved.

Under administrative law, the distinction between the liability of the director and of the company must be applied again. Certain administrative laws stipulate specific obligations of directors, such as tax legislation, public procurement legislation, and trade license legislation. A failure to comply with such obligations would result in the direct administrative liability of the director.

However, a much larger group of public law regulations stipulate obligations that the company must comply with. These regulations include environmental laws, anti-money laundering legislation, and accounting legislation. A breach of these laws would give rise to the administrative liability of the company. Subsequently, the company would have recourse against the board of directors who acted (or failed to act, as the case may be) on behalf of the company. The subject matter of the recourse may, for example, be the amount of the fine paid to a regulator.

The Criminal Code regulates a number of offences that can be committed by a director. If the facts of the case suggest that the elements of a particular offence have been met, the liability of the director would be considered under the Criminal Code. Examples of criminal offences that may be committed by directors include embezzlement (section 213 of the Criminal Code); fraudulent bankruptcy (section 227 of the Criminal Code); caused bankruptcy (section 228 of the Criminal Code); violation of obligations to manage another person's property (section 237 and 238 of the Criminal Code); and obstructions at bankruptcy and settlement proceedings (section 242 and 243 of the Criminal Code).

In the context of criminal liability of directors, another interesting criminal offence is the indirect criminal liability of legal persons. This type of liability was only introduced into Slovak law in 2009.

Pursuant to section 83a of the Criminal Code, the court may impose the confiscation of the monetary sum upon a legal entity if it committed, attempted to commit, or participated in the commission of a criminal offence in connection with: a) the performance of an authorisation to represent such legal entity, b) the performance of an authorisation to make decisions on behalf of such legal entity, c) the performance of an authorisation to perform a control within such legal entity, or d) the negligence of the supervision or due diligence within such legal entity. The court may impose the confiscation of a monetary sum from EUR 800 to EUR 1,660,000. The court shall not impose the confiscation of the monetary sum if it imposes a protective measure of confiscation of assets upon the legal entity under section 83b of the Criminal Code.

Pursuant to section 83b of the Criminal Code, the court may impose the confiscation of assets upon a legal entity if certain criminal offences were committed, even at the stage of an attempt or if there was participation in a criminal offence referred to in section 58 Subsection 2 or 3, and if the legal entity acquired assets or a part thereof through criminal activity or from the proceeds of criminal activity, in the same connections as stipulated in section 83a of the Criminal Code.

As outlined above, the criminal liability of a legal person must be distinguished from the liability of its director. Nevertheless, given the nature of the legal person, even those acts that give rise to the liability of the legal person (rather than the director) have been committed by the director acting on behalf of the company. Thus, such indirect liability relationship opens up an entirely new sphere of potential secondary liability of a director vis-à-vis the company. As expected, due to its novelty, this concept has not been subject to judicial scrutiny.

4.1.2 Role of case law

As mentioned above, case law generally does not have a precedential effect under Slovak law. However, two exceptions to this are the rulings of the Constitutional Court on constitutional matters and the quasi-precedential rulings of the Supreme Court as the court of last instance in the Slovak court system.

Since only the cases that get all the way up to the Supreme Court are published on a systemic basis, there is not very much case law concerning this topic. However, in this context, please note that as of 1 January 2012, all court judgements are now published on the Ministry of Justice of the Slovak Republic’s website (www.justice.gov.sk). The website includes a number of searchable parameters. Of course, the publication of judgements is subject to certain rules on the anonymisation of personal data. We expect the website will increase the awareness of court practice and possibly enhance the consistency of decision-making. We therefore would not characterise case law as settled, but instead as still evolving.

4.2 Conditions of liability

There are no specific conditions or a generally accepted test to establish a breach of duty. As discussed above, the duty of care of a director is outlined briefly in section 194(5) of the Commercial Code and comprises the duty to act with professional care and the duty to act in accordance with the interests of the company and all of its shareholders. In order to establish a breach of a directors' duty, it is sufficient to demonstrate that the director failed to exercise his or her powers with due professional care or in accordance with the interests of the company and all its shareholders.

However, while there is no generally accepted test for the breach of duty, the breach of duty itself is one of the three constituent elements for establishing that a particular director is liable for damage. The three elements that constitute liability for breach of duty under Commercial Code are:

Damage;

Breach of duty of the director; and

A causal link between the damage and the breach of duty.

Please note that when analysing the nature of the breach of duty and liability, two distinct situations must be distinguished:

Breach of duty relating to the director

In this case, the company will be the primary entity to enforce the liability claim against the director. There are certain exceptions – for example, under section 194(9) of the Commercial Code, the claims for damages that a company has against members of the board of directors may be exercised by a creditor of the company acting in his or her name and on his or her own account, if he or she is unable to satisfy his or her receivable from the company's property.

Liability of the company caused by the director acting on behalf of the company

Unlike in the first case, in this second scenario the company as a separate legal entity will be liable, rather than the director acting on behalf of the company. Nevertheless, the company will have recourse against the director for the damage suffered as a result of its liability.

4.2.1 Burden of proof

The prevailing opinion of academics is that the burden of proof in relation to directors' liability is borne by the director. In order to avoid liability, the director must be able to prove that he or she acted with due professional care and in accordance with the interests of the company and its shareholders[19]. The most frequent justification offered as to why the director should bear the burden of proof is that the liability regime of directors is special and stricter than the general regime.

[19] Patakyová, 2010, p. 583; Ovečková, 2007b, p. 233, Škrinár, 2008, p 127.

However, as Duračinská has observed, there exist two rulings of the Supreme Court of the Slovak Republic that are in fact both contrary to the prevailing opinion of the academics.[20] In both rulings, the Supreme Court confirmed that the basic principle of civil procedure that the claimant must prove its claim also applies to cases concerning liability for damage, including the liability for damage of directors. In the context of litigation regarding liability of damage, the obligation to prove the merits of the claim translated into the obligation to prove all elements that constitute liability for damage pursuant to the Commercial Code. Because court decisions are not binding on the subsequent decision-making of the courts, one cannot consider this issue as settled, especially in the face of compelling arguments put forward by legal experts in academia.

4.2.2 Evidence proving the fulfilment of the directors' duties

A director will have to prove that he or she acted with due professional care, that is, that he or she obtained and used all relevant information to make a decision in the matter that caused the damage in question. The director must also prove that he or she acted in good faith to ensure that his or her actions served the interests of the company.

The specific evidence that may be used by a director to prove that he or she acted with professional care and good faith varies. The evidence could include the director having obtained the opinion of in-house experts (such as lawyers and accountants) and external advisors, market forecast, legal opinions, and economic analyses. Given that the Commercial Code refers to the directors' duty to obtain, and also to consider such opinions in the decision-making, the mere obtaining of such opinions from internal or external advisors would not relieve the director of liability, if such director failed duly to consider the obtained information.

Specific evidence that is also relevant at law is the consent of the general meeting. Under section 194(7) of the Commercial Code, members of the board of directors shall bear no liability for any damage caused to the company by their conduct in executing a decision of the general meeting. However, this exception does not apply if the general meeting's decision is contrary to the law or articles of association.

Please note that the same level of protection does not apply to consent granted by the supervisory board. Members of the board of directors are not relieved of liability if their conduct was approved by the supervisory board.

In this context, the possibility to challenge a resolution of a general meeting before a court must be taken into account. If, for example, a minority shareholder successfully challenged a general meeting resolution on grounds of breach of law or of the Articles of Association, the resolution would no longer absolve the director from liability.

The considerations mentioned above regarding the dissenting vote of one director at a board meeting could also play a role in relieving that director of liability as the minutes recording the vote of the individual members would be good evidence to be used in the subsequent apportioning of liability among the board members (although, *prima facie*, it would probably not relieve the dissenting director of her liability, as discussed above).

[20] Duračinská, 2012.

With respect to the discretion in using various types of evidence, in the case of a dispute, both the company and the director have discretion as to what evidence they wish to use in the litigation proceedings to prove or disprove that the director fulfilled his duties.

The use of evidence and its timing must comply with the general procedural rules prescribed by the Code of Civil Procedure. The use of evidence must also comply with the legislation concerning classified information and sensitive information.

4.3 Exemptions and limitations

A member of the board of directors shall bear no liability for damage if he or she proves that he or she proceeded in exercising his or her powers with professional care and in good faith that he or she was acting in the company's interest. Members are not liable for their conduct, if it is based on a resolution of the general meeting unless such resolution was contrary to the law or the articles of association. An approval by the supervisory board, on the other hand, does not relieve directors of their liability[21]. It should be noted that it is rare in Slovakia for a company to sue its director or former director.

The Slovak law places certain conditions and restrictions on transactions with directors. Pursuant to section 196a of the Commercial Code, a member of the board of directors, proxy or other person who is entitled to act on behalf of the company and persons related to them or persons who act on their account may be granted credit or a loan by the company; have company property transferred to them or provided for their use; or have a liability secured by the company only with prior consent from the supervisory board and on an arms' length basis. If the same director also acts on behalf of another company, the scope of the restriction is also extended to such other companies.

Please also see the question below for the non-compete list of restrictions on directors.

Directors are free to pursue business opportunities; however there are two statutory restrictions: (i) conflict of interest and (ii) non-compete provisions.

(A) Conflict of interest

The general obligation of loyalty to the company prevents a director from pursuing a business opportunity that would conflict with the interests of the company and all of its shareholders.

(B) Non-compete provisions

The Commercial Code contains a relatively broad clause outlining conduct that a member of the board of directors is prohibited from engaging in. A member of the board of directors must not:

Enter into, in his or her own name or on his or her own account, business arrangements that are related to the company's entrepreneurial activity;

Mediate the company's business arrangements for other parties;

[21] See Angelika Masurova,"Vorstandshaftung im slowakischen Aktienrecht " in: Susanne Kalss, Vorstandshaftung in 15 europäischen Ländern (Vienna: Linde 2005) 830.

Participate in the business activity of another company as a shareholder or member with unlimited liability; and

Be an executive or a member of the board of directors or of another legal entity with a similar subject of entrepreneurial activity, unless the company in which he or she is a member of its statutory body participates in the entrepreneurial activity of such legal entity.

Importantly, the non-compete restrictions contained in the company's articles of association may only be stricter than the statutory provisions; the restrictions must not provide for a more lenient regime.

Under section 65 of the Commercial Code, a company may demand that a person who violates the non-compete restriction surrender to the company any benefits gained from the transaction, or that that the person in breach of the non-compete provisions transfer the corresponding rights to the company. Furthermore, this special remedy is without prejudice to the right to damages belonging to the company.

4.4 Insurance against liability

A director may take out an insurance policy that covers the risk of damage caused by his or her exercise of office. Such insurance policies often include the insurance of the damage itself; litigation costs, including the costs of lawyers; and the costs of public relations and defence of reputation of his or her reputation. Nevertheless, the general terms and conditions of such policies sometimes contain exclusion clauses that limit the reimbursement of costs to "efficiently spent costs"; specifically exclude certain types of liability such as criminal liability and some types of administrative liability; and generally tend to exclude wilful acting and gross negligence.

4.5 Consequences of liability

The liability of a director is a strict liability, and is not fault-based. Usually, strict liability is the general principle of liability under the Commercial Code. In order for liability under Commercial Code to exist, fault does not have to be proved. However, the liability of directors, besides being a strict liability, also shifts the burden of proof from the company to the director (see below for further information). However, it is important to point out that the objective, no-fault-required liability cannot be understood as the liability for the business result of a company, but merely as the liability for the conduct of the director[22].

Under section 194(6) of the Commercial Code, members of the board of directors who have breached their obligations while exercising their powers are obliged to jointly and severally compensate the damage thus caused to the company. Thus, this provision introduces the concept of joint and several liability of members of the board directors. In this context, one of the debated issues is the effect of a dissenting vote in the resolution of the board of directors. For example, in a scenario where there are three members of the board of directors and one of the directors voted against a certain measure, yet the measure was adopted by the majority of two out of three members of the board, and it was later revealed that the measure adopted breached the statutory directors' duties, it is not clear whether the dissenting vote, as recorded in the minutes of the board resolution, would relieve the dissenting director of liability for the breach. On the one hand, the

[22] Eliáš, 1999.

general provisions of the law concerning joint and several liability would apply to such situation[23]. Among these provisions is section 383, according to which jointly liable parties will apportion the liability among themselves depending on the extent to which they contributed to the liability. At the same time, there are opinions of academics that the dissenting vote *per se* would not relieve a director of his or her liability, if the board collectively proceeded with the action that gave rise to liability.[24]

Please note that under Slovak law, it is not generally obligatory for the board of directors to be a collective body. That is, the board of directors can be a sole-member board consisting of only one director (unless specific laws in certain regulatory fields state otherwise). Naturally, this concept would only apply to board of directors with more than one director. Internally, the directors would subsequently reach a settlement among themselves according to the scope of their liability.

Importantly, there is no universal test to establish the negligence of a director. A case-by-case analysis would be needed for each dispute. However, in this context, the concept of good faith plays an important role. As outlined above, on the one hand, fault (that is, the subjective element of a director's conduct) is not required to give rise to the liability of a director. At the same time, the director must act in good faith to ensure that his or her conduct is in the interest of the company. Although the concept of good faith apparently introduced a subjective element into the construction of directors' duties, it is in fact a mental element that must be distinguished from fault[25]. The concept of good faith is a more objective criteria.

[23] Patakyová 2010, page 582.
[24] Ovečková, 2012, p. 889.
[25] Patakyová, 2010, p. 583.

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 The meaning of 'vicinity of insolvency'

The law does not define the time of "vicinity of insolvency". The Act on Bankruptcy stipulates the time period in which the creditor may defeat the legal acts performed by the debtor in the past (generally this is for the past five years, although for insurance companies it is only for the past three years). However, we do not consider this time period as falling within the "vicinity of insolvency".

Based on section 3 of the Act on Bankruptcy, both the cash flow test as well as the balance sheet test is applied to determine the triggering event. A debtor is insolvent if it is unable to pay its debts as they mature or its liability exceeds its assets and it is therefore over-indebted. If the debtor petitions for declaration of bankruptcy, it means that the debtor is bankrupt. A person is unable to pay its debts as they mature if, 30 days after maturity, the person is not able to pay at least two monetary obligations to more than one creditor. A person is over-indebted if the person must keep books under the special law (a joint stock company fulfils this prerequisite), has more than one creditor, and the value of its obligations exceeds the value of its property.

5.2 Change of existing duties

Under section 14(5) of the Act on Bankruptcy, commencement of bankruptcy proceedings means that the debtor must restrict its activities to the ordinary legal acts only, and if the debtor breaches this obligation, it will not affect validity of the legal act; however, it is possible to defeat the legal act in the bankruptcy procedure.

Under section 44 of the Act on Bankruptcy, after the court declaration of a bankruptcy, the directors' right to dispose of the company's property is shifted to the administrator appointed by the court. The administrator acts in the name and at the account of the debtor. Legal acts performed by the debtor during the bankruptcy procedure, if those acts cut the property, are not effective towards the creditors (the validity of the legal acts is not affected).

In principle, the duties and to whom they are owed do not change in the vicinity of insolvency. Under section 4 of the Act on Bankruptcy, a debtor must prevent bankruptcy. If a debtor is under the threat of bankruptcy, the debtor must without undue delay adopt appropriate and reasonable measures to prevent it. A joint stock company must continuously monitor developments of its financial situations and the balance of its property and obligations so that it is able to discover the potential threat of its bankruptcy and to take measures that will prevent the threatened bankruptcy.

Under section 108 of the Act on Bankruptcy, if a debtor is under the threat of bankruptcy or is bankrupt, the debtor may charge the administrator (selected from a separate list held by the court) with working out restructuring expert opinions in order to find out whether prerequisites for a restructuring are given.

5.3 Newly arising duties

The Slovak legislation does not motivate the members of a board of directors to file a petition for a bankruptcy, even though the chance to satisfy the creditors would be higher[26]. This was the conclusion of Andrej Glézl who performed a research project at the Faculty of Law, Comenius University in Bratislava on the motivations of directors to file a petition for a bankruptcy, and on the enforcement of liability of directors[27].

The time period for filing a petition for bankruptcy is stipulated in section 11 of the Act on Bankruptcy. [28] As discussed above, the nature of directors' duties is not changed in the vicinity of insolvency. However, the main purpose of the bankruptcy procedure is satisfaction of creditors' claims and this is the aim of the administrator.

[26] E.g. Members of the board of director who brought the company to bankruptcy must not become members of the board of directors in the next several years (mainly in banks and other financial institutions) – as per Glézl, A. (2009).

[27] Glézl, A., 2010, states the following: Research conducted with the Slovak courts points out that there is no single case when a creditor would enforce such liability against corporate directors. It is so in spite of the fact that, according to the statistics presented by the Slovak Ministry of Justice, almost half of the bankruptcy cases commenced by the courts in the years 2008-2009 were dismissed or canceled due to the fact that the debtor did not have sufficient assets for liquidation purposes. These facts lead to the conclusion that the current system of director liability does not present a sufficient deterrent for director malpractice and cannot be considered as a sound value preserving mechanism for insolvent corporations.
The work by Adler et al. and by Warren & Westbrook can inspire academics in the Slovak Republic to conduct a more in-depth research of insolvency proceedings and measure the benefits of legal institutes against real values from the corporate world. Besides the information already published by the Ministry of Justice at its website, the courts should collect the following information in cases of corporate bankruptcies for the period of at least six to 12 months prior to the commencement of the case, at the time of filing and at the time the proceedings have terminated:

1. the debtor's industry;
2. the liquidation value of the debtor's assets;
3. the level of the debtor's outstanding debt (divided by long and short-term);
4. the debt to equity ratio;
5. detailed breakdown between secured and non-secured claims;
6. the debtor's actual turnover;
7. the debtor's profit & loss statement;
8. the debtor's working capital levels; and
9. the methodology for calculating the above values.

The real effect of various insolvency law provisions on the life of a corporation could be evaluated more precisely thanks to the availability of such data.
Glézl concludes as follows: The threat of consequent liability for damages seems not to be working as a deterrent for corporate directors to refrain from delayed filings for corporate insolvency proceedings. Thus this institute does not help preserve the residual corporate value for the involved stakeholders. Even though the exact effects of these liability provisions are still being researched, it is worth investigating whether the negative trend of value deterioration in delayed insolvency proceedings should not be managed by positive motivation of corporate directors, who could be financially rewarded from the future corporate profits in case they commence the insolvency proceedings early enough and help in the process of the necessary corporate reorganization.

[28] The bankrupt debtor must submit the petition for declaration of bankruptcy within 30 days from the day it became aware of, or, if it acted with professional care, could become aware of, its bankruptcy. The statutory body or a member of the statutory body of the debtor, the liquidator of the debtor and the statutory representative of the debtor is obliged to do the same on behalf of the debtor.
A creditor may submit the petition for declaration of bankruptcy if the debtor has been in default with payment of that creditor's monetary obligation for more than 30 days and insolvency of this debtor can reasonably be expected. Insolvency of a debtor can reasonably be expected if the debtor has been in default with payment of at least two monetary claims of at least two creditors for more than 30 days even though the creditors of these claims requested the debtor in writing to repay them.
If the person that must submit the petition for declaration of bankruptcy on behalf of a debtor violates the obligation to submit the petition for declaration of bankruptcy on time, it is presumed that the damage incurred by creditors is the in amount their receivables that have been not settled after the bankruptcy procedure, unless another amount of damage is proved.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue

6.1.1 The company as plaintiff

The following entities may instigate legal proceedings against the board of directors: (i) The supervisory board on behalf of the company for compensation of damage and claims towards members of the board of director as guarantors, (ii) minority shareholders, if the supervisory board does not act upon the request of minority shareholders without undue delay, (iii) the creditor of the company on his or her own behalf and to his or her own account, provided that he or she cannot satisfy his claim against company from company's assets; and (iv) the bankruptcy trustee acting on behalf of the creditors in case of bankruptcy.

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6.1.2 The shareholders as plaintiffs

In their own name

As discussed above, generally the board of directors shall perform its competence with due care, including professional care and in compliance with the interests of the company and all of its shareholders. In particular, the board of directors must not jeopardise the interests of its shareholders and cannot prefer its own interests; interests of selected shareholders; or interests of third persons to the interests of the company.

Nevertheless, section 194(7) stipulates that a director will be relieved of the liability if he or she is able to prove that she acted with professional care and in good faith that in acting in accordance with the interests of the company. Importantly, this section does not refer to the interests of shareholders. It is therefore fair to conclude that a single shareholder cannot bring a claim in his or her own name. Such a shareholder would still have certain general remedies available, the exact scope of which depends on the percentile of his or her shareholding. These general remedies may include proposing that his or her grievance be discussed at the next general meeting; calling for the convening of an extraordinary general meeting; and notifying the supervisory board of the perceived breach.

In the name of the company (‘derivative action’)

Individual shareholders can enforce claims of the company against the board of directors provided that (i) the shareholder owns at least five per cent of shares of the company (this condition may be fulfilled by several shareholders owning together at least five per cent of shares of the company) and (ii) the supervisory board failed to claim the rights of the company towards the board of directors upon the request of minority shareholders without undue delay. Please note that the Articles of Association of the company in question may stipulate a lower threshold for the standing to sue of minority shareholders.

Derivative lawsuits play a two-fold role: in companies with a controlling shareholder derivative lawsuits constitute a tool of protection of the minority shareholders against the controlling shareholder, whereas in a dispersed capital structure derivative lawsuits are a tool of protection of (all) investors against the directors.[29]

[29] Lasák, 2011, p. 93.

6.2 Criminal and administrative sanctions

Under section 194(5) of the Commercial Code, agreements between the company and a member of the board of directors that exclude or limit the liability of the member of the board of directors are prohibited. Further, the articles of association may not limit or exclude the liability of a member of the board of directors. When applying a "substance over form" approach, this restriction would also apply to an indemnity.

In terms of *ex post* mechanisms aimed at reducing the liability of director, a company may waive claims for damages that it has against members of the board of directors, or may enter into a settlement agreement with the directors only after three years from the establishment of such claims, provided that the general meeting gives consent to such waiver and that a minority of shareholders with shares whose nominal value comprises at least five per cent of the registered capital do not record a protest against such decision in the minutes at the general meeting. Importantly, the resignation of a director does not relieve him or her from liability for the breaches committed during his or her term of office.

7 CONFLICT OF LAWS

7.1 Classification under Slovakia's private international law

The rules set out in the 7.2 only apply to the duties of directors under the Commercial Code. For example, in the regime governing tortious liability, in the context of an intra-EU cross border issue, the relevant provisions of Regulation 864/2007/EC on the law applicable to non-contractual obligations (Rome II) would apply (the Rome II Regulation). Article 1(2)(d) explicitly excludes from its scope all torts arising in the corporate context ("non-contractual obligations arising out of the law of companies and other bodies corporate or unincorporated regarding matters such as the creation, by registration or otherwise, legal capacity, internal organisation or winding-up of companies and other bodies corporate or unincorporated, the personal liability of officers and members as such for the obligations of the company or body and the personal liability of auditors to a company or to its members in the statutory audits of accounting documents").

Consequently, Article 4(1) would apply, that is, the general rule, whereby the applicable law would be the one of the country in which the damage occurs irrespective of the country in which the event giving rise to the damage occurred and irrespective of the country or countries in which the indirect consequences of that event occur. However, two exceptions are possible:[30]

The exception of convenience

Pursuant to Article 4(2), where the person claimed to be liable and the person sustaining damage both have their habitual residence in the same country at the time when the damage occurs, the law of that country shall apply.

The exception of a "manifestly close relationship"

Pursuant to Article 4(3), where it is clear from all the circumstances of the case that the tort/delict is manifestly more closely connected with a country other than that indicated in paragraphs 1 or 2, the law of that other country shall apply. A manifestly closer connection with another country might be based in particular on a pre-existing relationship between the parties, such as a contract, that is closely connected with the tort/delict in question.

The liability of directors can have overlap with the conflict of laws relating to jurisdiction in commercial matters. In this context, the judgment of the Court of Justice of EU in the case Berliner Verkehrsbetriebe[31] is of importance. In that case, the Court dealt with the question of whether the scope of Article 22(2) of the Brussels I Regulation also extends to proceedings in which a company or legal person objects, in relation to a claim made against it stemming from a legal transaction, that the decisions of its organs which led to the conclusion of the legal transaction are ineffective as a result of infringements of its statutes. [32] The Court of Justice ruled that that Article 22(2) must be interpreted as not applying to proceedings in which a company pleads that a contract cannot be relied upon against it because a decision of its organs which led to the conclusion of the contract is supposedly invalid on account of infringement of its statutes.

Cross-border issues concerning insolvency are regulated separately under the Council regulation EC No 1346/2000.

[30] Pauknerová, 2008.
[31] Case C-144/10 Berliner Verkehrsbetriebe (BVG), Anstalt des öffentlichen Rechts v JPMorgan Chase Bank N.A., Frankfurt Branch.
[32] Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

7.2 Application of the relevant private international law rule

For the purposes of this report, a cross-border situation means a situation in which the state of the governing law of a company is different from the state of nationality and/or residence of the director and/or the state in which the board of directors is situated and makes its decisions (that is, the place in which the company is managed).

The conflict of law rules (international private law) in relation to the governing law of companies (corporations) has not been harmonised at the European Union level. Therefore, each Member State is free to elect a connecting factor that will cause a company to be governed by its law, provided that such connecting factor is one of the options offered by Article 54 of the Treaty on the Functioning of the European Union. These options include the company's registered office, central administration, or principal place of business. Based on such selection, the Member States of the European Union are traditionally divided into two groups. The first group of Member States applies the "state of incorporation" rule, according to which the applicable law is that of the state in which the company is incorporated or registered, irrespective of whether it has a physical presence there. The second group of Member States apply the "real seat" doctrine. According to this doctrine, the national courts will review the reality of the situation rather than the legal form and will therefore regard the applicable law as being that of the Member State in which the company has its main centre of operations (such as its head office or principal place of business), rather than that of the state of incorporation.[33]

In Slovakia, the connecting link that brings a company under Slovak law is the registered office. This is evident from section 21(2) of the Commercial Code, according to which a legal person with its registered office in the territory of the Slovak Republic shall be considered a Slovak legal person for the purposes of that Act.

Thus, if the registered office of a company is situated in Slovakia, the liability of a director of that company for the breach of directors' duties would be determined under the Slovak law. This is the case regardless of whether that director is a national of the Slovak Republic or not and whether his permanent residence or domicile is situated in the Slovak Republic or abroad. However, the rules for considering cross-border situations differ according to the character of the directors' duties and liability.

[33] Barnard, 2010, p. 331.

DIRECTORS' DUTIES AND LIABILITY IN SLOVENIA

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CONTENTS

1 INTRODUCTION

1.1 Basic legislative overview of the Slovenian corporate law

Being a "civil law country", Slovenia has a statute-based legal system, where the Parliament creates law (as proposed by the Government) in a multi-phase parliamentary procedure, whereas courts interpret and apply it to cases brought before courts by claimants. Court decisions are mandatory for the parties, but they do not have a precedent value. The Supreme Court of the Republic of Slovenia is the highest appellate court in the country.

Following the first Companies Act of 1993,[1] Slovenia adopted a new and modern companies act in 2006 (ZGD-1),[2] which includes rules on corporate governance as well as corporate finance matters. It has already been amended many times since then, usually as a consequence of transposition of the EU Directives into the Slovenian legal system. Its model acts have been the German and Austrian Companies Acts.

General rules on corporate governance and corporate finance that apply to all companies incorporated in Slovenia are included in ZGD-1. Nevertheless, there exists a special regime for companies that perform specific (usually highly regulated) activities (e.g. credit institutions, investment firms, insurance companies or management companies), which is regulated as *lex specialis* in separate legislation.[3] In addition, one has to note that certain public entities executing public services on behalf of the state or local communities may be organised in the corporate form. Therefore, if not otherwise regulated by the statute, general rules in ZGD-1 apply to them as well.[4]

Rules on "going public" (or the so-called "floatation rules") are not part of ZGD-1. They are included in the Market in Financial Instruments Act (ZTFI) instead[5], where a public company is defined as an issuer whose securities have been admitted to trading on the regulated market in the Republic of Slovenia or another Member State.[6]

Listed companies must in addition comply with the Corporate Governance Code (the Code)[7] whose provisions are not binding (mandatory) for companies. However, the companies must disclose which provisions of the Code they do not abide by and explain why (the "comply or explain" principle). The purpose of the Code is to define the governance and management principles of companies listed on the Slovene regulated market. The recommended practices can also be applied by other companies, so as to contribute to a transparent and understandable governance system in Slovenia, which promotes both domestic and foreign investor confidence into the Slovene corporate governance system, as well as the confidence of employees and the general public.[8]

[1] Official Gazette RS, Nos 30/93, 29/94, 82/94, 20/ 98, 84/98, 6/99, 45/2001 (ZGD).
[2] Official Gazette RS, No. 46/2006.
[3] ZBan-1, ZTFI, ZZavar and ZISDU-2.
[4] Cf. Article 28 of ZGJS.
[5] Articles 36 to 98 of ZTFI.
[6] Article 99 of ZTFI.
[7] The Code was jointly adopted by the Ljubljana Stock Exchange, the Slovenian Directors' Association and the Managers' Association of Slovenia. The Code incorporates the Slovene legislation, the guidelines and recommendations of the European Union, principles of business ethics, internal bylaws of the three institutions and internationally recommended standards of diligent and sound corporate governance.
[8] Cf. Preamble of the Code.

There are two more pieces of legislation that concern companies (and especially directors' duties and liabilities). One of them is the Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act (ZFPPIPP), which regulates *inter alia* the financial operations of companies, both outside and within the insolvency proceedings.[9] [10] Rules on appointment of employee representatives to the board are included in the Worker Participation in Management Act (ZSDU) *(see section 3.2. for details)*.[11]

1.2 Overview of the corporate landscape in Slovenia

A company within the meaning of ZGD-1 is a legal person, which independently pursues an activity with a view to profit in the market as its exclusive activity. An activity with a view to profit within the meaning of ZGD-1 is any activity pursued in the market for the purposes of obtaining a profit.[12] There are a number of ways a company may be incorporated in. Namely, companies under ZGD-1 shall be organised in one of the following forms:

- As "personal companies": an unlimited company, a limited partnership and a dormant partnership;
- As "companies with share capital": a limited liability company, **a public limited company**, a limited partnership with share capital and a European public limited company. Companies listed above shall be deemed to be companies also if, pursuant to the law, they pursue wholly or partly an activity without a view to profit.

Under the Companies Act of 1993, a Supervisory Board was compulsory for companies fulfilling certain conditions imposed by law, relating to the size of the company, the number of its employees and shareholders, the way it was founded and whether it was listed on the Stock Exchange.

In the year 2006, the system of compulsory two-tier corporate governance was abandoned. However, in practice the two-tier system still prevails in Slovenia nowadays due to the fact that the great majority of public companies transformed themselves from former social companies through the process of privatization and legal transformation.

Selection of the management system is now (since 2006) left to the shareholders. The management and supervisory bodies of the public limited company shall be the management board, the board of directors and the supervisory board. A public limited company may choose a two-tier management system by appointing a management board and a supervisory board or a one-tier management system by appointing a board of directors. In practice the vast majority of companies opt for a two-tier management system. The composition and the number of members of the management or supervisory bodies shall be determined by the statute and the articles of association. The management or supervisory bodies shall be composed of at least three members, unless otherwise provided by the statute (exemption: the management board of a PLC using the two-tier system may be composed of less than three members). If a management or supervisory body has more members, one of them shall be appointed chairman. As shall be explained below, directors (correctly the management board) run the company independently and at their own responsibility, which also means that shareholders and/or members of the supervisory board as a rule must not and cannot interfere in

[9] Notwithstanding the first paragraph of Article 27 of ZFPPIPP, Chapter 2 of ZFPPIPP shall not apply for banks, insurance undertakings, brokerage companies, and management companies.
[10] Directors' general duties and liabilities in the field of financial operations of the company outside insolvency are outlined in sections 4.5. and 5.2.3. of this report. Special rules concerning directors' duties and liabilities before the onset of insolvency proceedings are explained in section 6 of this report.
[11] Please note that ZSDU does not apply to banks (cf. Paragraph 2 of Article 1 of ZSDU and paragraph 4 Article 60 of ZBan-1).
[12] Paragraphs 1 and 2 of Article 3 of ZGD-1.

the business decisions and therefore cannot give "instructions" to directors on how to manage the company as this would jeopardise and undermine their independence.[13] However, in one-tier systems the executive directors shall follow the instructions given by the board of directors or shareholders meeting.

When outlining the ownership structure of Slovene companies, it has to be noted that in the early '90s all companies undertook a transformation from a "collective social ownership" into modern "western" individual ownership structure. The state is an important owner of many strategically important companies through the following five entities: Slovene Compensation Company *(Slovenska odškodninska družba d.d.)*, Pension Fund Management *(Kapitalska družba d.d.)*, PDP, Special Company for Corporate Advisory *(PDP, Posebna družba za podjetniško svetovanje d.d.)*, D.S.U., Company for Advisory and Management *(D.S.U., družba za svetovanje in upravljanje, d.o.o.)*, and The Capital Assets Management Agency of the Republic of Slovenia *(Agencija za upravljanje kapitalskih naložb (AUKN))*.[14] Cross-ownership between larger companies also exists. It is therefore difficult to argue that the ownership structure is widely dispersed. On the contrary, as far as large public limited companies are concerned, it is still rather concentrated. It is very difficult, however, to obtain any reliable and official data.

The capital market in Slovenia is accordingly small in terms of the number of market participants and of market capitalisation, and shallow in terms of liquidity. The only stock exchange is Ljubljanska borza, d. d., Ljubljana (Ljubljana Stock Exchange), Member of the CEE Stock Exchange Group (CEESEG). The main figures on the Annual Turnover and the Market Size of the Ljubljana Stock Exchange can be found in Table 1 and Table 2 below.[15]

[13] Cf. Paragraph 1 of Article 265 of ZGD-1 and section 4.4. of this report below.
[14] Through AUKN the State has a participation in 99 companies. For details see: <http://www.auknrs.si/f/docs/Predstavitev/Seznam_11_november_2011.pdf> (accessed on 17 February 2012). It has been reported that the State through all 5 entities has a participation of EUR 10.7 billion in Slovenian companies altogether (<http://www.finance.si/341284/Kako-upravljati-11-milijard-premoženja-da-ga-bo-kdo-kupil>) (accessed on 22 February 2012).
[15] Annual Statistics Ljubljana Stock Exchange Year 2011 Year XVII., No. 12/11, (<http://www.ljse.si/cgi-bin/jve.cgi?doc=1520&sid=>) (accessed on 25 February 2012).

Table 1: Annual Turnover for 2011

Market	Turnover in 000 EUR	Volume in pieces	Number of trades
Shares	394,476	12,012,918	83,286
Prime Market	344,728	8,023,908	56,788
Standard Market	25,476	1,449,301	9,587
Entry Market	24,272	2,539,709	16,911
Bonds	59,580	1,159,105	2,668
Investment coupons	3,672	3,262,645	4,469
Investment funds	12,335	12,105,289	7,157
Short-term securities	0	0	0
Total	**470,064**	**28,539,957**	**97,580**

Table 2: Market Size in 2011

Market	Market Capitalisation (in EURm)	Number of securities	Number of issuers
Shares	4,873	68	76
Prime Market	3,696	9	9
Standard Market	578	17	17
Entry Market	599	42	40
Bonds	14,459	70	20
Investment coupons	20	1	1
Total	**19,352**	**139**	**76**

2 CONCEPT OF COMPANY DIRECTORS

2.1 Requirements and a process to become a company director[16]

In terms of nomotechnics ZGD-1 is structured in a way that it first provides common rules for management and supervisory bodies (in a public limited company), while it differentiates between special rules for management and supervisory boards in subsequent sections.[17]

As mentioned above it is the management board as a collective body that represents and acts on behalf of a public limited company.[18] The management board consists of one or more members (unless otherwise provided by statute), who shall be appointed for a period determined in the articles of association, which shall not be longer than six years, with the possibility of reappointment. Any natural person with legal capacity may be a member of the management board, other than a person:

- Who is a member of another management or the supervisory body of such company;
- Who has been finally convicted of a criminal offence against the economy, against labour relations and social security, against legal transactions, against property, against environment, space and natural resources. Such a person cannot be appointed to the supervisory board within five years as of the finality of judgment and two years after having served the sentence;
- Against whom a security measure has been passed prohibiting the pursuit of a profession, for the duration of the prohibition; or
- Who, acting as a member of the management board of a company against which bankruptcy proceedings were instituted, has been pronounced liable to repay damage to the creditors in accordance with the law regulating the financial operations of companies for the period of two years after the court ruling became final.[19]

Members of the management board shall be appointed by the supervisory board. A reappointment may not be made earlier than one year prior to the expiry of the term of office of the management board member.[20]

The supervisory board may recall a particular member of the management board or the chairman:

- If he is in serious breach of obligations,
- If he is incapable of business conduct,
- If the general meeting passes a vote of no confidence in him, except where the vote of no confidence was passed for clearly unsubstantiated reasons, or

[16] See also section 7.3. below on directors' disqualifications.
[17] Cf. Articles 253 to 264 of ZGD-1 (Common provisions for management and supervisory bodies), Articles 265 to 272 (the Management Board), Articles 273 to 284 (the Supervisory Board), Articles 285 to 291 (the Board of directors).
[18] The management board shall manage a company independently and on its own responsibility. The management board may have one or more members (managers). If the management board has more than one member the members shall adopt the decisions unanimously, unless otherwise provided in the articles of association. The articles of association may not provide that in the event of a difference of opinion the vote of a particular member or particular members shall prevail over the majority. (Article 265 of ZGD-1).
[19] Paragraph 2 of Article 255 of ZGD-1.
[20] Paragraph 1 of Article 268 of ZGD-1.

- For other economic and business reasons (significant changes in the shareholder structure, reorganisation, etc.).[21]

When filing the application for management board member to the Court register, his/her statement shall be enclosed, in which he/she consents to the appointment and where he/she confirms that there are no reservations to his appointment listed above. A notary public shall certify the signature of a person giving that statement.[22] Once all the conditions have been fulfilled, the Court register then issues an order by which it enters the management board members (with certain particulars) in the Court register. It has to be noted, however, that such a court order has a declaratory effect[23] and that a director is a lawful and effective director as of its appointment by a supervisory board.[24]

Should a company choose the one-tier management system, then the board of directors shall represent the company, manage it and supervise its operations. The board of directors may appoint one or more executive directors. Members of the board of directors may be appointed executive directors. If the board of directors appoints executive directors from amongst its members they shall present and represent the company unless otherwise provided in the articles of association. The president of the board of directors may not be an executive director of the company.[25]

The provisions laid down in articles 255, 267, 273, 274 to 276, 278, 279, 281, 282 of ZGD-1 (which apply to management and/or supervisory board members) shall apply *mutatis mutandis* in respect of members of the board of directors.

The board of directors may assign the following tasks to the executive directors:

– Management of regular operations;
– Applications for registration and submission of documents to the registry;
– Taking care of keeping the books of account; and
– Compilation of the annual report to which, if subject to auditing, the auditor’s report and the proposal for the use of net distributable profit for the general meeting shall be attached and immediately submitted to the board of directors.[26]

In performing the tasks, the executive directors must comply with the instructions and the restrictions imposed by the general meeting, the board of directors, the articles of association and the rules of procedure of executive directors. If there are several executive directors, they shall conduct business together, unless otherwise provided in the articles of association or the rules of procedure of the board of directors.[27]

The board of directors may recall an executive director at any time. The rules regulating obligation relations shall be used to decide claims based on a contract to perform the function of executive director.

[21] Article 268 of ZGD-1.
[22] Paragraph 2 of Article 5 of the Court Register Decree.
[23] A particular fact or information has a declaratory effect on the day of its publication in a public register and it is deemed that from than on it is known to everyone. A right/legal relationship is created notwhithstanding the publication in the register. On the other hand a constitutive effect of the entry means that by the entry (and only by the entry) in the register a right or legal relationship is established (e.g. foundation or winding up of the company).
[24] See the Supreme Court decision, ref. n. III Ips 176/2007, dated as of 02.04.2010.
[25] Paragraph 2 of Article 289 of ZGD-1.
[26] Paragraph 4 of Article 290 of ZGD-1.
[27] Paragraphs 5 and 6 of Article 290 of ZGD-1.

The provisions laid down in Articles 261 to 264 and 269 to 271 of ZGD-1 shall apply *mutatis mutandis* in respect of executive directors.

2.2 Employee participation in managing bodies

Employee participation in the corporate bodies of a company is carried out through the employees' representatives in the management board (in the board of directors for one-tier management systems) and in the supervisory board of the company. The articles of association determine the number of employees' representatives in the supervisory board, but according to the statute it shall not be less than a third and not more than half of the members of the supervisory board of the company. The board of directors shall consist of at least one employees' representative and it must be at least one employee that is appointed among three newly appointed members of the board. An employees' representative cannot be a chairman of the supervisory or the board of directors. He is appointed by the employees' council, which then notifies the general meeting of shareholders about the appointment.[28]

A company with two-tier management system, which employs more than 500 employees, has a "workers' director" in the management board. Based on the proposal of the employees' council, he is appointed by the supervisory board. The same applies mutatis mutandis for the "workers' executive director" in one-tier management systems.[29]

Workers' directors (both in the management board and in the board of directors) share and are bound by the same duties and liabilities as other directors according to provisions of ZGD-1 and ZFPPIPP, but among their duties they should represent especially interests of employees regarding employment and social issues.[30]

2.3 Directors in financial institutions

In case of credit institutions (hereinafter: banks) only the persons authorised by the Bank of Slovenia to perform the function of members of a bank's management board may be appointed members of such bank's management board. The bank's management board shall comprise at least two members, who shall jointly act on behalf of and represent the bank in legal transactions. None of the members of the bank's management board or the procurator may be authorised to act independently on behalf of the bank with respect to the entire extent of the bank's activities. Members of the bank's management board shall manage the bank on a full time basis. At least one member of the management board shall have a working knowledge of the Slovene language necessary to perform the duties of management board member properly. The management board shall manage the bank's operations in the Republic of Slovenia.[31]

Members of the bank's management board may only be appointed persons:

- Having appropriate professional qualifications and possessing the characteristics and

[28] Article 79 of ZSDU.
[29] Article 81 of ZSDU.
[30] Article 84 of ZSDU.
[31] Article 62 of ZBan-1.

experience necessary for managing the bank's operations, and

- Who have not been convicted, by a final judgment, either of an intentionally committed criminal offence that is prosecuted *ex officio* or of one of the following criminal offences committed by negligence: negligent homicide, serious bodily injury, extremely serious bodily injury, threatening work safety, concealment, disclosure and undue obtaining of professional secrecy, money laundering, disclosure of official secret, causing general danger or disclosure of state secret, and the penalty has not yet been expunged from the criminal record.

Unless proved otherwise, the condition about relevant shall be deemed to have been fulfilled if the person has at least five years' experience in managing the operations of a company of the size and activity comparable to that of the bank or any other similar operations.[32]

Similar conditions apply to directors of insurance companies, investment firms and management companies.[33]

2.4 De jure, de facto and shadow directors

2.4.1 Definition

Neither the legislation nor the jurisprudence in Slovenia recognises a division between *de jure* directors, *de facto* directors and shadow directors. It has to be noted, however, that the legal doctrine has come across this issue and that the terms are not completely unknown in the Slovenian legal community. To establish that a person is a *de jure* director is usually[34] easy as this can be found out by looking in the Court register. In addition to the valid appointment, a director has to fulfil conditions set in Article 255 of ZGD-1 *(see above under point 3.1.)*. Both *de facto* and shadow directors are characterised as persons who run (manage) the company in addition or instead of *de jure* directors. Neither of them has a valid legal entitlement for such activity, but they differ in their subjective attitude to their operations. Namely, a shadow director (in fact) manages and represents the company even though he does not have the authority for that and he is not entered in the Court register as a director. He therefore hides behind a *de jure* director and in relations to third parties does not want to disclose himself (i.e. *de jure* director acts according to his instructions). On the other hand, a *de facto* director pretends and presents himself to be a true director, but he has not been (properly) appointed to that position. He therefore does not have a valid legal title to hold a position of a director, but he acts as if he had it. A shadow director always acts in cooperation with a *de jure* director, while a *de facto* director shall usually act alone and on his own. A shadow director and a *de facto* director can both be legal persons, which is not conceivable for a *de jure* director. A deputy director may in certain circumstances be considered a *de facto* director.[35]

It is undisputable that directors' duties apply to *de jure* directors, who may then be held liable for breaching them. Furthermore, the legislator provides for liability arising from the influence of third persons.[36] It can be persuasively argued that this provision applies to shadow directors (but not to *de*

[32] Article 63 of ZBan-1.
[33] Articles 157 and 158 of ZTFI, Article 24 of ZZavar, Article 55 of ZISDU-2.
[34] "Usually" shall refer to circumstances, where (after a new director has already been appointed) a previous director is still entered in the Court register and due to the constitutive effect of the appointment only an inquiry at the Court register will not suffice.
[35] Ilić, p. VI-VII.
[36] Cf. Article 264 of ZGD-1.

facto directors), as they "*use their influence on a company to induce a member of the management or supervisory body, the procurator or a proxy to act in a manner which causes damage to the company or its shareholders*".[37] For further and more detailed analysis of Article 264 of ZGD-1 please see section 5.2.4. below.

2.4.2 Intra-group transactions

ZGD-1 contains also special rules on transactions between affiliated companies (i.e. intra-group transactions). For the purpose of this report the focus will be mainly on the actual[38] and contractual[39] concerns of companies and the management and its liability in respect of each of them. It is of particular interest to see how the corporate governance rules deal with liability of the management of the dependent and the dominant (controlling) companies, where, by means of mandatory instructions, the management of the dominant company induces the management of the dependent company to take or omit an action (activity). On the one hand, this represents an exception to the general rule that the management runs the company independently and on its own risk, while on the other hand, functionally, it resembles the issue of a shadow director, since a person (in this case a company), who is not a director, effectively influences a management decision.

2.4.2.1 Contractual concerns

In relation to contractual concerns the dominant company shall have the right in a controlling contract to give instructions concerning the business conduct to the dependent company. Unless otherwise provided by the contract, instructions may also be given to the detriment of the (dependent) company if they benefit the interests of the dominant company or concern of companies. The management of the dependent company must fulfil the instructions of the dominant company and may not refuse to carry out instructions even if it is of the opinion that they do not benefit the interests of the dominant company or companies affiliated with it. If an instruction is given to the dependent company for it to carry out an operation which requires the approval of the supervisory board and that approval is not given within an appropriate period, the management must notify the dominant company of this. If after receiving this notification the dominant company repeats its instruction, the approval of the supervisory board shall no longer be required; if the dominant company has a supervisory board it may only repeat the instruction with its approval.[40]

As far as liability of a dominant company and its management is concerned the dominant company must settle any annual loss of a dependent company arising during the period of the contract if it is not settled from other profit reserves to which profit was transferred during the period of the contract. If a dependent company leased one of its establishments to the dominant company or relinquished it to the dominant company in some other manner, the dominant company must settle any annual loss arising during the period of the contract if the agreed funds are not sufficient to cover it.[41] It's a duty of

the management of a dominant company to give instructions correctly and carefully. If they are in

[37] One time inducement would not suffice. There must be a systematic inducement by a third party, so that a director would conclude transactions under third party's influence constantly and on a regular basis. For further details, see Varanelli, p. XIII-XIV.
[38] An actual concern shall comprise a dominant company and one or more dependent companies connected under the unified management of the dominant company. (paragraph 1 of Article 530 of ZGD-1)
[39] A contractual concern shall comprise companies connected by a controlling contract. (paragraph 1 of Article 530 of ZGD-1)
[40] Article 541 of ZGD-1.
[41] Article 542 of ZGD-1.

breach of their obligations they shall be jointly and severally liable to the company for damage arising. In the event of doubt as to whether they have correctly and carefully fulfilled their obligations, they shall bear the burden of proof that they have done so. A compensation claim by the company may also be pursued by any shareholder of the company, but they may only claim payment for the company (i.e. reflexive damage). Compensation claims may also be pursued by creditors of the company if the company is unable to repay them. Claims against the management shall be time-barred after five years.[42]

The management[43] of a dependent company shall also be jointly and severally liable in addition to the liable persons listed in the previous paragraph if they acted in a way that was in breach of their duties. In the event of doubt as to whether they have correctly and carefully fulfilled their duties, the burden of proof shall be on them. Liability for damages shall not be excluded by the fact that the supervisory board approved the relevant actions. The management shall not be required to compensate for damages caused if the harmful action was based on an instruction, which it was necessary to fulfil in accordance with the dominant company's instructions.[44]

2.4.2.2 Actual concerns

In case of an actual concern (i.e. where a controlling contract has not been concluded) the dominant (controlling) company may not use its influence to induce a dependent company into carrying out harmful transactions for itself, or into doing something or failing to do something to its own detriment, unless the dominant company compensates the dependent company for the loss. If the loss is not compensated for during the financial year, it shall be necessary to determine when and how the loss shall be compensated for at the latest by the end of the year in which the dependent company suffered the loss. The dependent company shall be guaranteed a right of priority with respect to compensation. Within the first three months of the financial year the management of a dependent company shall compile a report on relations with the dominant company.[45] [46]

If a dominant company induces a dependent company to carry out a legal transaction which is detrimental to it, or to do something or not do something to its own detriment, without actually compensating for the loss by the end of the financial year or without providing the right to benefits determined for compensation, it must reimburse the dependent company for the damage suffered. A compensation claim by the company may also be pursued by any shareholder of the company, but they may only claim payment for the company (i.e. reflexive damage). Compensation claims may also be pursued by creditors of the company if the company is unable to repay them. Shareholders of the company may also claim compensation for damage caused to them irrespective of the damage that

[42] Article 543 of ZGD-1.
[43] The same applies to members of the supervisory board.
[44] Article 544 of ZGD-1.
[45] This report shall state all the legal transactions which the company concluded in the past financial year with the dominant company or with companies affiliated with it, or at the initiative or in the interest of these companies, and all other actions which it carried out or omitted to carry out at the initiative or in the interest of these companies in the past financial year resulting in loss for the company. If there were no such transactions, this must be clearly stated in the report. For legal transactions the payments and repayments shall be stated, and for actions the reasons for them and the benefits or the loss accruing to the company. In compensating for a loss it shall be precisely stated how such compensation actually proceeded during the course of the financial year and whether the company was guaranteed the right to benefits and to what benefits. The report must conform with the principles of conscientiousness and reliability. At the end of the report it shall be necessary to explain whether the company, in the circumstances known to it at the time when a legal transaction was carried out or an action was taken or not taken, received suitable payment for each legal transaction and whether, when the action was taken or not taken, it suffered a loss. If it suffered a loss, it must clarify whether that loss was compensated for. The clarification shall be included in the business report. (Paragraphs 3 to 5 of Article 545 of ZGD-1)
[46] Article 545 of ZGD-1.

was caused to them with the damage to the company. In addition to the dominant company, those representatives of the dominant company who induced the dependent company to carry out the legal transaction or measure shall also be jointly and severally liable.[47]

The management of a dependent company shall be jointly and severally liable if they did not state the harmful legal transaction or the harmful action in the report on the company's relations with affiliated companies or if they did not state that the company suffered a loss as a result of a legal transaction or action and that the loss was not compensated for. In the event of a dispute as to whether they have correctly and carefully fulfilled their duties, they shall be required to demonstrate that they have done so. A loss need not be compensated for if the action was based on a lawful resolution passed by the general meeting.[48]

2.5 Conclusion of the first part

Despite some terminological inconsistencies (e.g. director/management board member) one can conclude that a system of appointing and requirements to become a director in a public limited company are clear and very straightforward. The Court register has modernised and filing now takes place electronically by a notary public, who serves as guarantee that a person being appointed is in fact the one who is then registered in the Court register. Since no formal education is required to become a director, it can be argued that the standard of care, which shall be discussed in the next section, is not proportional, especially if one compares some other professions, such as doctors, solicitors, etc., which need to act in accordance with the highest standard of care as well. The concept of shadow directors is recognised in legislation and the intra-group transactions, including liability for damage caused, are regulated in details.

[47] Article 547 of ZGD-1.
[48] Paragraphs 1 and 3 of Article 548 of ZGD-1.

3 Scope of directors' duties

3.1 Legislative overview of directors' duties and their applicability

There is no exhaustive and detailed list of directors' duties in the Slovene legal system. Moreover, they are not covered in one statute only, but their regulation is rather shared between two basic statutes.[49] ZGD-1 contains general rules about diligence, responsibilities and duties of management board members, which apply *mutatis mutandis* also to directors in private companies (d.o.o.)[50] and public companies (d.d.) with a one-tier board structure *(see section 4.2. below)*. ZFPPIPP on the other hand deals with directors' duties in the field of managing financial operations *(see section 4.5. below)*. It has to be noted that ZFPPIPP regulates financial operations of companies within insolvency as well as outside insolvency. Since the substance of duties and their nature are not self evident from the wording of ZGD-1 and in order to understand them properly, one has to focus first on basic principles of corporate and civil law in terms of the directors' legal status *(see point 4.2. below)*.

As the name suggests, directors' duties apply to persons being appointed directors, therefore a person who is no longer a director (his mandate or term of office terminated voluntarily or involuntarily) is generally not bound by directors' duties. There is however doubt as to whether it is not appropriate that certain duties "survive" the termination of office of a director. The legislation provides for a ban on competition also after the expiration/termination of the director's term of office *(see below)*, and it is quite common that a similar provision is included in a contract between the director and the company.

3.2 Types of directors' duties

The directors' obligations to manage a company may be classified as a **service**. Its objective is to perform certain tasks (activities) in order to achieve or try to achieve a specific purpose (i.e. to achieve the ultimate goal (purpose) for which the company was established). Therefore, it is of the utmost importance to know when a service has been performed properly – either when the final result is achieved (obligation of result) *("obligacija rezultata")* or when a person is endeavouring to achieve a final result with due (professional) diligence (obligation of effort) *("obligacija prizadevanja")*. It is undisputed in the legal theory[51] and in judicial practice[52] that directors' duties are obligations of effort, which means that when managing a company's business and operations a director shall endeavour with due (professional) diligence to fulfil the company's (and shareholders') most fundamental goal – i.e. long-term sustainable growth as well as maximising the market value of the equity by maintaining short- and long-term payment solvency of the company.[53]

[49] In addition, directors' duties of banks, insurance companies, investment firms and management companies are regulated by legi speciali, namely ZBan-1, ZZavar, ZTFI and ZISDU-2, respectively.
[50] Article 515 of ZGD-1 with reference to Articles 263 in 264 of ZGD-1.
[51] Plavšak, 2008, p. 44.
[52] Judgment of the High Court of Ljubljana, ref. n. I Cpg 510/2010, dated as of 16.09.2010.
[53] Plavšak, 2008, p. 41.

3.2.1 Duty of care - to act with due professional diligence

Having the fundamentals in mind we may now briefly turn to directors as professionals and to the standard (duty) of (professional) care as a criterion to assess the directors' activities. A professional is any person (natural or legal) who enters into legal transactions in relation to his profession or activity and who offers specific performance (e.g. services) for which the particular knowledge, experience or qualifications are required.[54] When assessing a professional's activity it is not important that a professional in fact possesses the necessary knowledge, experience or qualifications. It is enough that he acts in such a way in circumstances, where such level of diligence is supposed to be typical, as is average for a person who performs the same activity and has the required specific knowledge, experience or qualifications. Directors perform their duties related to the management of companies as professionals, since special knowledge and experience are needed to perform them correctly and adequately. Therefore, it is deemed that a person who gives his consent to the appointment as a director has the required knowledge and experience. Consequently his actions shall be judged to the highest standard of care, which is higher (more stringent) than the standard of a reasonable man. When performing obligations arising from their professional activities participants in obligational relationships must act with high diligence, according to the rules and customs of the profession (the diligence of a good expert).[55] A criterion to judge whether a professional has acted with the diligence of a good expert is the typical, common, average, frequent conduct of the average professional from the same field of expertise in the same circumstances. The substance of the duty of care (i.e. diligence of a good expert) is abstract (objectivised), which means that the same measure (criterion) is applied to assess activities of all professionals within the same area of expertise. It is therefore not important if a particular person (professional) has the required (typical, average) knowledge, experience or qualifications.[56]

Directors, being professionals in managing companies, are subject to the highest standard of care and it is therefore their primary duty to act with the diligence of a good expert when performing management activities. Nevertheless, while ZFPPIPP provides that directors shall act with the diligence of a good expert,[57] ZGD-1 on the other hand stipulates that directors "must act with the diligence of a conscientious and fair manager", which is a less stringent criterion of a duty of care. It is a firm opinion of the legal doctrine that the duty of care denoted in the first paragraph of Article 263 of ZGD-1 shall be interpreted and construed as the highest diligence of a good expert and not as a diligence which is in any case required/expected from a reasonable person in commercial transactions.[58] The Supreme Court of the Republic of Slovenia also shares this view.[59] The substantial assessment of the required professional diligence can only be done by considering rules, customs and expertise established within the particular profession.

The main function and competence of directors is the management of a company independently and on their own responsibility.[60] ZGD-1 does not say what "managing a company" means or encompasses, but directors are obliged to undertake certain measures in many circumstances. There are more "technical" duties of directors derived from the duty of care.[61] The following list is not

[54] Plavšak, 2008, p. 46.
[55] Paragraph 2 of Article 6 of OZ.
[56] Plavšak, 2008, p. 47 and 48.
[57] Paragraph 2 of Article 28 of ZFPPIPP.
[58] Plavšak, 2008, p. 48 and Bohinc, 2006, p. 314. Some experts (e.g. Ilić) however have been more in favour of a more textual interpretation and have argued that the standard of care in ZGD-1 is different to the standard of professional diligence.
[59] The Supreme Court decision, ref. n. III Ips 75/2008, dated as of 21.12.2010.
[60] Paragraph 1 of Article 265 of ZGD-1. High Court of Ljubljana decision, ref. n. I Cpg 1370/2010, dated as of 15.02.2011, the Supreme Court decision, ref. n. VIII Ips 472/2006, dated as of 25.10.2007.
[61] It is not the intention of this report to deal with each of directors' obligations under ZGD-1 and other statutes.

exhaustive and it concerns only duties of the management board members under ZGD-1. The management board shall:

- Have certain powers and obligations in respect of the general meeting;
- Report to the supervisory board;
- Prepare and submit to the supervisory board the annual report and the proposal for the use of the profit for appropriation;
- Submit a proposal for the appointment of a member of the supervisory board to the court immediately after it establishes that the number of members is insufficient and does not guarantee quorum;
- Immediately announce any change in the membership of the supervisory board and notify the change for entry in the register;
- Notify the name and surname of the chairman and the deputy for entry in the register;
- Require the general meeting to determine whether to give consent in cases where the supervisory board refuses to give its consent;
- Decide by a simple majority on whether to convene the general meeting;
- For each item on the agenda on which the general meeting is to decide propose resolutions for adoption in the publication of the agenda;
- Have special tasks in relation to convening the general meeting;
- At the general meeting give the shareholders reliable information on matters concerning the company;
- File a request to register a company (and all subsequent changes to its corporate structure) to the Court register;
- Review the process of setting-up the company and to call the shareholders to pay their contributions;
- Have special obligations in the process of capital increase/decrease; and
- Have specific competences in nullity and voidness or when challenging resolutions of the general meeting.

In addition to directors' duties listed above, which mainly concern relations within the company itself and its corporate bodies, directors (the management board) shall represent the company. If the management board has more than one member, the members shall represent the company jointly, unless otherwise provided in the articles of association.

Directors shall abstain from all actions that could lead to causing damage to the company. The expected diligence of a director is not definitely defined *(ex ante)*. It may differ according to the size, activity and situation of the company, as well as the division of responsibilities among the management board members. The management board shall exhaust all sources of information and knowledge and hire external advisers if it does not have the required knowledge itself. If the management board considers supervisory board resolutions to be in breach of valid legislation or to the detriment of the company, it shall inform the supervisory board of its reservations and contribute to the avoidance of damage accordingly.[62]

3.2.2 Duty of loyalty – to act in company's best interest

Management board members shall always and unconditionally follow and act according to the company's best interests. They must prevent the emergence of the impression that they are biased when the interests of third parties clash with the interests of the company. The duty of loyalty also

[62] Rečnik, p. 68.

prevents the management board members from abusing their position to satisfy their own interests and to gain any advantage in relation to the company's business. Therefore, interests of the company must be safeguarded also when the directors' pursue their own interests. In cases of severe breaches of this duty, the criminal law[63] steps in as well (e.g. in case of depletion of the company's assets or the dependent company).

The duty of loyalty may be further characterised as:

- The duty to act loyally in favour of the company;
- The prohibition on the abuse of power in order to satisfy one's own interests (e.g. self-dealing and corporate opportunities);[64]
- The duty to consider the company's interests when pursuing one's own interests; and
- The subsequent duty of loyalty (after termination/expiration of the term of office).[65] But note that there is no legal rule stipulating that the duty of loyalty continues after the end of the mandate.

The duty of loyalty may also encompass a duty to protect business secrets and a ban on competition. Nevertheless, in this report a special section has been dedicated to these two duties because ZGD-1 explicitly addresses them. Considering their content, they represent a "sub-set" of the duty of loyalty, since both protect the company's interests.

In 2011 the legislator amended ZGD-1 by introducing a new article on "abolition" of conflicts of interests. Directors (and also procura holders) may conclude an agreement with another company, in which he or his immediate family member or both hold a share of at least 10% of the share capital or he or his immediate family member is member of a "dormant company" *("tiha družba")* or in any other way participates in its profits, only with the consent of the supervisory board (or the board of directors, as applicable).[66] If a board member who should decide on granting the consent to the agreement is an immediate family member or a member of the "dormant company", he should exclude himself from voting.

Directors shall in three working days notify the supervisory board (or the board of directors) in case of conclusion of an agreement as defined in the previous paragraph if he or his immediate family members hold less than 10% of the share capital.

Until the amanedments of 2012 (ZGD-1 G), directors under Slovenian law had no general duty to avoid conflicts of interest. A general prohibition of the exploitation of any property, information or opportunity for the directors' own interests did not exist. Directors were not required to ensure that they did not put themselves in positions where there was a conflict between their personal interests and their duties to the company (as they are for example in UK law). ZGD-1 G has introduced a general legal obligation to avoid conflicts of interest.[67] According to 38.a ZGD-1 G (elimination of conflicts of interest), members of the management or controlling organ of the company must avoid any conflict of their interests or duties with the interests of the company that they manage or control. In the

[63] Article 240 (Abuse of Position or Trust in Business Activity) of KZ-1.
[64] See section 6.2. on challenging legal actions of a debtor (in bankruptcy).
[65] Rečnik, p. 69.
[66] Should the copmany not have the supervisory board (possible in d.o.o. companies), the general meeting shall give its consent.
[67] A conflict of interest exists if the impartial and objective performance of the tasks or decision-making by the director is threatened because of a personal economic interest, the interest of a family member, or any other interest in relation to another natural or legal person.

event of a conflict of interest, the persons referred to must inform the management board and supervisory board or, if the company does not have a supervisory board, the shareholders at the next general meeting.

Article 38.a also contains an interesting provision stipulating that the director's liability is not excluded, even if the general meeting passes a resolution by which it gives its consent to the transaction.[68] In the absence of consent, the agreement is null and void *(ab initio)*. ZGD-1 explicitly allows the articles of association to determine more stringent conditions for such an agreement/transaction than those outlined above.

3.2.3 Duty to protect business secrets and ban on competition

It is an obligation of the management (but not exclusively of the management) to protect business secrets[69] of the company. Members of the management board of the company and other persons shall be liable for any disclosure of a business secret if they knew or should have known that the data was of such nature. In a written resolution the company shall determine the method of protecting business secrets and the responsibility of persons obliged to protect business secrets.[70] It is also a criminal offence, if a person, *"without due authorisation in non-compliance with his duties to protect trade secrets, communicates or conveys information designated as a trade secret to another person, or otherwise provides him with access to such information or with the possibility of collecting such information in order to convey the same to an unauthorised person"*.[71]

Members of the management board may not participate in their role of a corporate officer or be an employee in any other company, or, as an entrepreneur, pursue an activity, which is or could present competition to the activity of the first company. The articles of association may set conditions under which they may however participate in a competing company. The articles of association may further provide that the ban on competition shall continue after a termination or expiration of term of office of the management board member. The ban may not last more than two years except in certain cases, when the ban may not last more than six months.[72] ZGD-1 rules on ban on competition shall not prejudice the prohibition on competition applying to persons in an employment relationship.[73]

If a person violates the ban on competition the company may claim compensation. The company may also require the offender to cede to the company any operations concluded for his own account as operations concluded for the account of the company, or require the offender to transfer to it any benefits from operations concluded for his own account, or to cede to the company his right to compensation. Claims of the company shall be time-barred three months after the company learns of the violation and of the offender, and within five years at the latest since the violation was committed.[74]

3.3 To whom are directors' duties owed?

[68] Cf. Article 263 of ZGD-1.
[69] A business secret shall be deemed to be data so determined by the company in a written resolution. The members, employees, members of management bodies of a company and other persons obliged to protect business secrets shall be acquainted with this resolution. Irrespective of whether it is covered in a resolution under the preceding paragraph of this article, any data whose disclosure to an unauthorised person would clearly cause substantial damage shall also be deemed to be a business secret. Information defined by law as public or information about violations of the law or fair business practice may not be determined as business secrets (Article 39 of ZGD-1).
[70] Article 40 of ZGD-1.
[71] Article 236 of the Criminal Code (KZ-1).
[72] Article 41 of ZGD-1.
[73] Please note the difference between (statutory) prohibition of competition and (contractual) competition clause. (Articles 37 to 40 of ZDR)
[74] Article 42 of ZGD-1.

It is not explicitly stated in the legislation to whom the directors' duties are owed. Nevertheless, one can argue that (during the ordinary course of business) they are owed to the company. Directors must always act in favour of the company. It is a common understanding that when doing so directors are executing, protecting and fulfilling mainly shareholders' interests (i.e. maximising the value of the equity – *see above*). Even though the greatest emphasis is given to shareholders and their interests, it would be incorrect to conclude that the Slovenian company law (especially in terms of directors' duties and liabilities) is shareholder-oriented. On the contrary, a company is a bundle of interests of many social groups, including shareholders, management, employees, market participants (e.g. suppliers), financial participants (e.g. banks), the state (e.g. the budget) and the society and public at large. In the Codex of Business-Financial Principles it is explicitly stated that shareholders' interests in the company shall prevail, but are as a rule limited by interests of other stakeholders.[75] As soon as a company becomes insolvent, creditors' interests prevail over interests of the shareholders and as a consequence directors' duties are then primarily owed to creditors, while the shareholders' interests become subordinated and may be protected only to the extent not detrimental to creditors.

3.4 Independence of the management board

It is important to note that the duty of "managing the company" cannot be transferred to the supervisory board. The general meeting of shareholders is also excluded from taking management decision, unless the management board asks it to take such a decision or if a supervisory board refuses to give its consent to the management board decision and it is then asked to give a consent.[76] The management board shall manage a company independently and on its own responsibility[77], always taking into account the interests of the company. The independence of the management board shall be deemed in terms of the relationship with shareholders, since the management board members are not bound by the "managing decisions"[78] of the supervisory board or the general meeting[79] as they are not within their competence. On the other hand, in a one-tier system the executive directors must observe instructions and limitations given by the general meeting or the board of directors, the articles of association or the rules of procedure.[80] The management board cannot therefore delegate its responsibilities and duties to other corporate bodies or individuals. It may pass any decision, which is not within the competence of the supervisory board or the general meeting of shareholders. The concept of independence of the management board and its members becomes even more important and more evident in cases where a management board member is a company's shareholder at the same time. His position may seem to be rather schizophrenic, but he must undoubtedly act in the sole interest of the company (which may well be different than his interest as a shareholder). A company, being a "legal creature" with its own legal personality, has and pursues its own interests and it is the management board, which protects these interests by the statutory authorisation. It is forbidden for third persons (e.g. shareholders) to use their influence and force the management board to adopt a business decision, especially if such a decision is just in their favour and to the detriment of the company. The independence of the management board is manifested also in special provisions on the liability of management board members, which shall be dealt with in

75 Point 2.1. of the Codex of Business-Financial Principles.
76 Paragraph 6 of Article 293 of ZGD-1.
77 Paragraph 1 of Article 265 of ZGD-1.
78 For instance, decisions on runing the company, its operations and business decisons.
79 Except in cases from paragraph 6 of article 293 of ZGD-1.
80 Paragraph 5 of Article 290 of ZGD. Please note that despite this difference their liability is still subject to the same rules that apply to the management board members (paragraph 11 of Article 290 of ZGD-1). Therefore, the current regime may not be optimal for executive directors, since if an intruction is given by the board of directors, the executive directors must execute it and as a consequence they may not be held liable for any damage that occurs as a result (providing of course that the instruction of the board is lawful).

details below in section 5.2.

3.5 Specific directors' duties and liabilities in the field of financial operations of a company

One of the most important aspects of managing the company, its business and operations is running the financial function of the company. It is so important that directors' duties and liabilities in terms of financial operations are additionally and separately regulated in ZFPPIPP. It is the management duty to ensure that the company's operation complies with ZFPPIPP and with the rules of the corporate finance profession. When managing company's operations, the management shall act with the professional due diligence of the corporate finance profession, thus endeavouring to ensure that the company is at all times liquid and solvent. Members of the management shall be jointly and severally liable for any damages arising as a result of violations of their obligations provided for in Chapter 2 of ZFPPIPP. Members of the management shall be free from liability if they can prove that in meeting their obligations, they were acting with the professional due diligence of the corporate finance and corporate governance profession.[81]

Every business decision brings financial consequences and it is very hard (if not virtually impossible) to foretell the outcome of business decisions. It is therefore vital that the management board manages risks that business and other decisions bring, as risks may have a severe impact on the company's liquidity and solvency. The risk management shall include the determination, measurement or assessment, management and monitoring of risks, including reporting on the risks to which the company is or could be exposed in its operations. The management shall ensure that the company provides for the regular implementation of the measures of risk management referred to in Articles 31 and 32 of ZFPPIPP[82], and other measures of risk management which are, under the rules of the corporate finance profession, necessary and appropriate as regards the types and extent of operations carried out by the company.[83] The management shall take into account all the risks to which the company is or could be exposed in its operations, and which include first of all credit, market, operational and liquidity risks. A company shall manage its sources (funding) and investments in such a manner that it is at any time able to meet its obligations as they fall due. The company shall ensure that it always has enough long-term sources of financing available, with respect to the extent and types of operation it executes, and the risks to which it is exposed in the execution of these operations. The management shall provide for the regular monitoring and checking of whether the company has attained capital adequacy.[84]

The regulation of a "sub-set" of directors' duties and liabilities in ZFPPIPP, which is in fact the Insolvency Act, should not cause confusion as the rules outlined above apply to all companies outside insolvency. There are special rules on management behaviour in the vicinity of a company's insolvency *(covered in section 6 below)* and the management role once the insolvency procedures commence *(cf. Article 245 of ZFPPIPP).*[85] Notwithstanding what has just been written, directors' duties and liabilities imposed by ZFPPIPP do not apply to banks, insurance companies, investment firms, and management companies as they have much stricter and more detailed rules on risk management

[81] Article 42 of ZFPPIPP.
[82] Management of liquidity risk and monitoring and ensuring capital adequacy.
[83] Paragraph 2 of Article 30 of ZFPPIPP.
[84] Article 32 of ZFPPIPP.
[85] This report does not cover directors' duties and liability after a company enters into any of the insolvency proceedings, but only the »pre-insolvency« period.

included in their “domestic” laws (i.e. ZBan-1, ZTFI, ZZavar, ZISDU-2). For a public limited company with a one-tier management system, the rules concerning supervisory (not management) board, provided for in chapter 2 of ZFPPIPP shall apply *mutatis mutandis* for its board of directors and its members.

3.6 Directors’ duties in the Codex of Corporate Governance

Not only are the duties of care (diligence of a good expert) and loyalty (acting in the interest of the company) at the heart of directors’ duties in the relevant legislation (i.e. ZGD-1 and ZFPPIPP), but they are also embodied in the Codex as the leading principles of the management board. It is recommended that the *“[c]ompany is managed by the management board, whose work, knowledge and experience ensure an optimum fulfilment of their function along with risk management and risk assessment, thus facilitating the company’s long-term performance. It is the management board that defines and stipulates the company’s values and operations strategy, while its organization facilitates an efficient performance of its tasks”*[86]. The management board shall be composed so as to foster the adoption of decisions in the best interests of the company. The management board consists of several members, who ensure a diligent and responsible meeting of the company’s objectives. The management board acts in compliance with high ethical standards and takes into account the interests of all groups of stakeholders.[87] It is emphasised that members of the management board make independent decisions. *“In taking action and making decisions, members of the supervisory and management board take account of the company’s objectives and subordinate to them the potentially different individual own or third party interests, the interests of the management board, shareholders, the public, and the government.”* As the interests between different stakeholders and the company may often clash, the management board shall take precautionary measures to avoid any conflict of interest that might affect their judgment.[88]

3.7 Directors’ duties in banks

As banks and other financial institutions manage, mitigate, but sometimes also create risks, which may have a very significant and adverse effect on the entire economy (a systemic risk), it is of even greater importance that directors’ duties (as well as liabilities) are elaborately stipulated.

Members of the bank's management board shall ensure that the bank's operations are consistent with:

- ZBan-1 and regulations issued for its implementation;
- Other acts governing the performance of financial services provided by banks, and other regulations issued for their implementation;
- Other corporate finance and banking rules; and
- With the highest ethical standards of corporate governance, considering the prevention of conflicts of interest.[89]

Members of the bank's management board shall be jointly and severally liable for the damage incurred as a result of the violation of their duties listed above, unless they can prove that they acted

[86] Rule 14 of the Codex.
[87] Rule 15 of the Codex.
[88] Rule 17 of the Codex.
[89] Paragraph 1 of Article 66 of ZBan-1.

with due professional care in the exercise of their managerial duties.[90]

The Bank of Slovenia adopted the Regulation, which *inter alia* deals in details with professional and ethical standards of the management at the bank level, their diligence, responsibility, autonomy and professional qualification. It is beyond the scope and purpose of this report to go into particulars of the banks' management duties, but a general observation to these rules imposed on them would be that they are stricter than those contained in ZGD-1. Similar rules apply also for management board members of insurance companies, investment firms and management companies.[91] There is no judicial practice related to these *(lex specialis)* rules, so their applicability and standards of duty of care remain to be seen.

Conclusion of legal transactions which are the fundamental reason for the bank's incurrence of exposure to a single individual in a special relationship with the bank (i.e. **a management board member**) and whose value exceeds 100,000 euros shall be subject to approval from the bank's supervisory board.[92]

3.8 Conclusion

There are three major duties that are imposed on directors of companies – to act with due professional diligence (duty of care), to protect the interests of the company (duty of loyalty) and to protect business secrets and a ban on competition. The three duties are not surprising since a legal relationship between a director and a company is an agency relationship *("mandatno razmerje")* which under the law of obligations imposes very similar duties on the agent.[93] A striking similarity between the agency contract regulated in OZ and the director-company relationship shall be observed in the area of liability as well (see section 5.2.1. below). The first two duties are prevailing and all others (more technical and operational) are subject to these two general rules.

Due to different (inconsistent) wording of the required standard of care of directors in ZGD-1 and ZFPPIPP there are some uncertainties whether two different standards of care apply to directors – one in the field of financial operations and one in all other areas of directors' responsibilities. It is the prevailing opinion of the legal theory and practice that only one standard of care shall apply (i.e. diligence of an expert or professional diligence). Special duties of managing risks in a way that a company remains liquid and solvent are imposed on directors by ZFPPIPP. In addition, the financial sector in the broadest sense regulates (some of) directors' duties and liabilities separately and in greater details. There are also "soft law" rules (e.g. in the Code) which reiterate the basic principles of statutory duties and liabilities with additional general plea on ethical and fair performance of directors.

[90] Paragraph 2 of Article 66 of ZBan-1.
[91] See Article 26 of ZZavar, Article 157 of ZTFI and Article 58 of ZISDU-2.
[92] Paragraph 2 of Article 167 of ZBan-1.
[93] *"The agent must execute the mandate according to the instructions received with the diligence of a good businessperson or the diligence of a good manager; in so doing the agent must remain within the agent's boundaries and at all times attend to the principal's interests, which must be the former's guide."* (Paragraph 1 of Article 768 of OZ)

4 LIABILITY FOR BREACH OF DUTIES

4.1 Liability in general

In order to fully understand the liability concept of directors, one shall need to take a look at general provisions on liability for damages in OZ. For any kind of liability for damages, the following four conditions must be fulfilled:

- (legally relevant) Damage (loss) *("pravno relevantna škoda");*
- Unlawfulness[94] - loss arises either from unlawful action (breach of general prohibition of causing damage or breach of contractual provisions) or unlawful consequence (which occurs as a consequence of lawful operation of a dangerous item) *("škodljivo ravnanje")*;
- Causation between unlawful action and loss *("vzročna zveza")*;
- Liability *(culpa)* of a responsible person who caused the loss ("liability in the narrow sense") *("krivda oziroma odgovornost")*.

General rules on liability recognise in principle two broad liability regimes – contractual and non-contractual liability for damages.[95] In addition OZ in Article 148 provides a special provision *(lex generalis)* on a legal person's liability for damage inflicted by body thereof. It stipulates that a legal person shall be liable for damage inflicted on a third person by a body of the legal person during the performance of its functions or in connection therewith. Unless stipulated otherwise by law for the individual case, the legal person shall have the right to demand reimbursement of the sum paid out from a person that inflicted the damage intentionally or out of gross negligence. This right shall expire six months after the day the compensation was paid. These rules apply in the absence of specific regulation *(lex specialis derogat legi generali).*

ZGD-1 and also ZFPPIPP include special provisions *(lex specialis)* on the liability for damages for directors as a consequence of breaching their duties. For liability issues that are not addressed in ZGD-1 or ZFPPIPP, general rules on liability for damages shall apply. It has to be noted that rules on liability are mandatory *(ius cogens)* and cannot be alleviated in the articles of association or in the contract with a director. It is also not permissible to provide in the articles for the right of directors to be indemnified by the company for the costs of proceedings in third party lawsuits or if they are acquitted. Whether the duties can be set out in a more stringent way is questionable.[96]

4.2 Distinction between contractual and non-contractual liability for damages

Before proceeding to the core part of this report, a more elaborate distinction and its significance between contractual and non-contractual liability shall be made. The main characteristic of the

[94] Unlawfulness does not necessarily mean something illegal. In case of directors' liability for unlawfulness to arise it is enough that directors breach their duties (by actions which may be perfectly legal but not in accordance with the required due professional diligence), under further condition that a damage has arised. If their actions are illegal, then they are *(a fortiori)* unlawful as well.
[95] See articles 131 and 240 of OZ.
[96] Dolenc, p. 119.

contractual liability for damages is a breach of the party's contractual obligation, which triggers the liability. Therefore, parties that are subject to this kind of liability have been in contractual relationship prior to occurrence of liability. A contractual obligation may be breached by its non-performance or incorrect performance (either delayed performance or performance with errors). In cases where a contractual service obligation is an "obligation of effort" a standard of the required duty of care (diligence) is applied when assessing if the obligation has been breached or not. Not acting in accordance with the required duty of care represents an incorrect performance of an obligation and creates unlawfulness as one of the conditions for liability. Having said that, it is evident that the relevant standard of acting with due diligence is applied to indicate (un)lawfulness and not to judge upon "liability in the narrow sense", which is not even a condition for contractual liability of damages.[97]

Subjects of the non-contractual liability for damages, on the other hand, are not in any kind of mutual contractual or business relationship. Liability for damages therefore stems from a breach of other (i.e. non-contractual) obligation or from a risk, which materialises in damage in the sphere of the affected party. "Liability in the narrow sense" is a condition for occurrence of this kind of liability and it is presumed.[98] Should a person want to relieve himself from non-contractual liability, he needs to prove that the damage has been caused without his "liability in the narrow sense" (culpability) as opposed to contractual liability, where a damaging party shall prove that he could not perform his obligation or that the delay has been caused due to circumstances, which occurred after concluding the contract that could not be prevented, remedied or otherwise avoided. Having acted with the required diligence and care shall therefore not be enough to be excluded from contractual liability, as one shall need to prove that the cause for non-performance (or delayed performance) came from outside its (business) sphere. To conclude this theoretical, but very important section, one has to realise that the required standard of diligence (which is used both in assessing the contractual and non-contractual liability for damages) is used to determine the existence of lawfulness in case of contractual liability and to determine the existence of culpability or "liability in the narrow sense" in case of non-contractual liability.[99]

4.3 Directors' liability for damages (in relation to a company)

Directors' liability is mainly regulated in ZGD-1. OZ general rules on liability for damages shall apply for questions not covered in ZGD-1. In addition, directors' liability in the area of financial operations of the company is included in ZFPPIPP. As mentioned above, even though ZFPPIPP is predominantly the insolvency act, this kind of liability (as well as corresponding duties) has nothing to do with insolvency. ZFPPIPP, however, also imposes specific duties on the management in the insolvency period, but before any insolvency procedure is initiated (for details see section 6 below).

In short, these are the basic fundamentals of liability regime for directors under ZGD-1. In performing their tasks on behalf of the company, members of the management board must act with the diligence of a conscientious and fair manager. Should they fail to do so, members of the management board shall be jointly and severally liable to the company for damage arising as a consequence of a violation of their tasks. They shall be exempt from liability if they demonstrate that they fulfilled their duties fairly and conscientiously.[100] The burden of proof is therefore reversed (for details please see section 5.2.2.).

[97] Plavšak, 2008, p. 60 and 61, Article 240 of OZ.
[98] Article 131 of OZ.
[99] Plavšak, 2008, p. 60 to 62.
[100] Article 263 of ZGD-1.

4.3.1 Analogy with the agency agreement and the liability thereunder

The academia[101] and the courts[102] unanimously agree that a "director-company" relationship is similar to an agency relationship under the agency agreement as regulated under Articles 766 to 787 of OZ. This is important for legal classification (and interpretation) of directors' duties and their liability, as it resembles the duties and liability of an agent under the agency agreement. Directors are basically entrusted with the management of property (assets), which (usually) belong to a third person, while an agent through the agency agreement undertakes to the principal to perform specific transactions therefor.[103] The three basic similarities between an agent under the agency agreement and a director of a company are:

- Considering the question of liability, a sample, typical average person is taken as a benchmark in both cases (a person with a diligence of good manager for the agency agreement and a person with professional diligence);
- A great emphasis is in both cases given to the interests of the company or the principal that must be protected and acted in accordance with; and
- Should there be more than one management board member or more than one agent, they shall be all jointly and severally liable[104].

In case of doubt of basic characteristics of the relationship between a director and a company, his duties and liability, one shall always refer to provisions of the agency agreement. Moreover, the High Court of Ljubljana in a decision, ref. n. I Cpg 15/2009 dated as of 21.05.2009, held that a claimant (a creditor) may claim damages from a defendant (director) not only on the basis of ZGD-1 rules on liability, but also on the basis of breaching the agency agreement that existed between the company and its director. The cause of action and the legal basis may be important because of different rules on time barring (5 years in case of breaching the agency agreement and 3 years under ZGD-1). Having classified a "director-company" relationship as an agency relationship, we may conclude that director's liability towards the company is a contractual one.

4.3.2 Conditions for and characteristics of directors' liability under ZGD-1

Directors' liability under ZGD-1 is contractual, subjective (i.e. culpable), joint and several and personal.[105]

Members of the management board shall be jointly and severally liable to the company for damage arising as a consequence of a violation of their duties, unless they demonstrate that they have fulfilled their duties fairly and conscientiously.[106]

Conditions for directors' liability and the entire concept of liability for damages in ZGD-1 shall be interpreted within the principles and liability for damages rules in OZ. The affected party shall prove the following three conditions for directors' liability:

[101] Bratina, p. 640.
[102] High Court of Ljubljana judgment, ref. n. I Cpg 15/2009, dated as of 21.05.2009.
[103] Paragraph 1 of Article 766 of OZ.
[104] Article 774 of OZ.
[105] Cf. Dolenc, p. 120.
[106] Paragraph 2 of Article 263 of ZGD-1.

- **Directors' breach of their duties** (=unlawful act)
  - Directors' duties have been analysed in detail in section 4.2. It is worth mentioning here again that their duties towards the company are statutory, but their relationship with the company is contractual. The legal nature of their duties is an "obligation of effort" and not an "obligation of result" therefore satisfaction of this obligation is measured through the required professional diligence with which they are required to act. It is the highest standard of care provided in OZ, since directors are considered to be professionals and experts in the field of managing companies.[107] A standard of care is therefore abstract and objective. Needless to say that this condition is fulfilled also in cases where directors breach any mandatory rule (*ius cogens* rule) imposed by the statute or other legislation.

- **Damage** (loss) suffered by the company (=affected party)
  - There is no liability, even if directors' breach their duties, if no damage is caused by the breach. Not every reduction of the company's assets, even though it is not connected to the company's activity and even if it does not increase the company's profits, represents damage to the company (e.g. expenses for culture, social expenses, etc). It needs to be established when such expenses are necessary and justified. One abstract criterion can be that the damage is a reduction of assets or unrealised profit, which would not arise in the hypothetical case of company's development, should directors manage the company correctly, diligently and conscientiously.[108]
  - Damage comprises the diminution of property (ordinary damage) *(damnum emergens)*, prevention of the appreciation of property (lost profits) *(lucrum cessans)*, the infliction of physical or mental distress or fear on another person, and encroachment upon the reputation of a legal person.
  - In practice it is very difficult to prove the existence and scope of damage.

- **Causation** between the breach of duties and the suffered damage
  - As there are more theories to address the causation issue, it is argued that in this case the parties and the courts should apply the "theory of adequate causation" *(teorija adekvatne vzročnosti)*, which very generally states that a result is a consequence of an action or an activity, if such an activity usually, frequently, as a rule leads to the very consequence arisen in the specific case.

The fourth element of the liability for damages – "liability in the narrow sense" or **culpability** – shall be presumed and does not need to be proven by the affected party. The burden of proof is therefore on the director(s) to show that they have acted fairly and conscientiously (i.e. in accordance with the required professional diligence). Should they succeed to prove that, they shall not be held liable, even though the three conditions listed above are fulfilled.

The management board is a collective body and all management board members are jointly and severally liable for damages caused to the company. This means that each member is liable for the entire damage suffered by the company (as a result of their breach of duties) and that the affected party may choose any or all members of the management board (including the board member who is a representative of employees) as a defendant and claim from each of them the payment of

[107] For linguistic discrepancies between ZGD-1, ZFPPIPP and OZ, please see section 4.2.1. With very few exceptions, it is argued that there is no doubt that directors' liability under ZGD-1 shall be assessed using the highest standards of diligence. This is supported also by the court cases.
[108] Bratina, p. 643.

compensation (damages), until the damage is fully recovered. Member(s) of the management board may then have the recourse right to claim payment of the damages from other members, but this is a general civil law principle and since it has nothing to do with their liability to the company, but rather with their internal relationships, I shall make no further analysis in this direction.

Members of the management board may be jointly and severally liable with members of the supervisory board, but liability of supervisory board members is beyond the scope of this report. In addition, in specific cases management board members may be jointly and severally liable with third persons (causing damage by intentional influence on management board members) (see section 5.2.4. for details).

4.3.2.1 Business judgment rule

In the course of managing company's activities, it is crucial to distinguish between a wrong business decision and a breach of directors' duties. Namely, every business decision, which causes loss to the company, is not (necessarily) in contradiction with the required standard of care. Business decisions are inherently associated with risks. Therefore they may cause profit as well as loss. On one hand, the management is looking for business opportunities, while on the other hand, it has to dare to adopt a decision, despite its riskiness. Equating any loss with damage to the company would be unreasonable and would have negative commercial consequences. Shareholders do not want to have totally risk averse directors in their offices as this decreases the possibilities for maximisation of their profit.

Courts always hear the case *ex post* when the result of a business decision is already known and even if they try to assess it from an *ex ante* perspective they might be influenced by the subsequent outcome. It is difficult then for the defendant to convince the court that he has acted with due diligence, if the loss or damage has already occurred. Directors shall have a degree of manoeuvring space for their business decisions.[109]

So, even though it does not stem from the statutory provisions in ZGD-1, certain legal experts (the Supreme Court Justice) in Slovenia have expressed willingness to accept and apply the US "business judgment rule"[110] in the Slovenian judicial practice.[111] This intention has only been indicated recently, after the German Supreme Court *(Bundesgerichtshof)* had adopted the business judgment rule doctrine in the case, ref. n. II ZR 124/06, dated as of 03.03.2008. There is no relevant judicial practice and it is hard to say whether the Slovenian courts shall follow the German example and introduce the doctrine of the business judgment rule in our law. It seems that such an approach to directors' liability by courts shall be welcome and beneficial for the Slovenian corporate law.

4.3.2.2 Company's waiver of the claim and set-off

There is a special provision in paragraph 3 of Article 263 of ZGD-1, which deviates from the general rules in OZ, about the company's right to waive compensation claims or offset them only three years

[109] Rečnik, p. 70-71.
[110] The business judgment rule provides a rebuttable presumption "that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company". Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); see also Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (explaining the purpose underlying the business judgment rule and discussing a director's duties under the rule).
[111] Dolenc, p. 124. Podgorelec, p. 982, Rečnik, p. 70, Obal, p. 71.

after the claims arose provided the consent of the general meeting is obtained and provided no written objection is made by a minority shareholders holding at least one-tenth of the share capital. The reasoning behind this provision is the statutory safeguarding of the company's assets, where the management board would simply waive the company's claim or offset it by the company's obligations with the management board members. This would be a very easy and utterly absurd way of excluding management board members' liability.

4.3.3 Liability for financial operations of the company under ZFPPIPP

Everything said so far about the contractual liability of directors applies also to a special duties regime (financial operations of the company) under ZFPPIPP. The management shall ensure that the company's operation complies with ZFPPIPP and with the rules of the corporate finance profession. When managing a company's operations, the management shall act with the professional due diligence of the corporate finance profession, thus endeavouring to ensure that the company is at all times liquid and solvent. Members of the management shall be jointly and severally liable for any damages arising as a result of violations of their obligations provided for in Chapter 2 of ZFPPIPP. Members of the management shall be free from liability referred to in this section if they can prove that in meeting their obligations, they were acting with the professional due diligence of the corporate finance and corporate governance profession.[112]

For enforcement rules of contractual liability under ZFPPIPP see section 7.1. For non-contractual directors' liability under ZFPPIPP see section 6.3.

4.3.4 Directors' liability for damages arising from the influence of third persons

Directors' liability for damages arising from the influence of third person[113] may be perceived as a special liability of the management, but its scope is much wider. It applies to members of the management or supervisory body, the procurator or a proxy. Persons who use their influence on a company to induce at least one of the persons from the preceding sentence to act in a manner which causes damage to the company or its shareholders must reimburse the company for the resulting damage. In addition to the members of the management or supervisory body anyone who derived benefits from the damaging action, if such action was committed intentionally, shall also be jointly and severally liable. The company's creditors may also pursue a compensation claim against the company if the company is unable to repay them.

It is evident from the statutory provision that this liability shall apply only in cases where intention of third parties is proven. Negligence of third persons (who has obtained a benefit) would not suffice.

Rules for this special liability shall not apply if a member of the management or supervisory body, the procurator or the proxy was committed to the damaging action in the exercise of:

- A voting right at the general meeting,
- A management entitlement based on a controlling contract, or
- A management entitlement for a principal company in which the company is incorporated.

[112] Article 28 of ZFPPIPP.
[113] Usually by the controlling shareholder.

A special interest shall be paid to the second sentence of the first paragraph of Article 264 of ZGD-1, according to which shareholders shall be reimbursed for damage if they suffered damage, irrespective of the damage that was caused to them through the damage caused to the company.[114] This kind of shareholders' damage suffered directly in their proprietary sphere needs to be distinguished from the damage suffered by the company and reflected through the lower share price. Legal theory distinguishes between damage suffered by the company and two kinds of damages suffered by shareholders. A company's damage may result in a decrease of their assets or prevention of its increase. Both of these reflect in the lower share price, which is a damage to shareholders (also called the reflexive damage *("refleksna škoda") (Refleksschaden)*). In addition a shareholder may suffer additional damage, which can only be claimed by shareholders' independent claims. On the other hand, however, a damage, which results in lower share price, cannot be claimed by shareholders on behalf of the company, but only by the company itself.[115] Some doubt has been recently expressed as to this, because a very textual interpretation of the Slovene version of the second sentence of Article 264 of ZGD-1 may lead us to the conclusion that shareholders may independently (besides the company) claim damages also for reflexive damage, which is a rather unusual outcome. Having copied this provision from the German Public Limited Companies Act (AktG, paragraph 117), the author of the critique of the Slovene provision argues that a "mistake" must have been "unintentionally" made during the translation.[116]

4.4 Exemptions from directors' liability

According to the general rules on liability for damages in OZ[117], the liable person for damages may exempt himself from liability if (1) he acted with consent of the affected party *(volenti non fit inuira)* or (2) he proves that the damage occurred as a consequence of a third party interference (action), which was outside his business sphere. In addition ZGD-1 provides that members of the management board shall not have to reimburse the company for damage if the act that caused damage to the company was based on a lawful resolution passed by the general meeting.[118] The liability of members of the management shall not be excluded on the basis that an act was approved by the supervisory board.[119] Two further comments need to be made with regard to the exculpating resolution of the general meeting (adopted by the ordinary majority of shareholders present). Firstly, it needs to be a **lawful** resolution *("zakonit sklep")* of the general meeting. Should it be unlawful (regardless of the reason) (e.g. inadequate majority, unlawful convening of the general meeting), then the management board members may be held liable, depending on the satisfaction of the other condition for liability. Secondly, even if the general meeting passed a resolution and approved the management board act, this act still has to be legal and **must not be illegal** *("protipraven")*. An illegal act cannot be validated by the lawful adoption of a resolution by the general meeting.

The company's ability to waive or offset its claim against directors (provided that all statutory conditions are met – see section 5.2.2.2. above) may also be seen as a way to exempt directors from liability.

[114] Please note that under Article 264 of ZGD-1 the aggrieved shareholders do not have their own claim against a third person (e.g. the controlling shareholder), which caused damage to the company.
[115] Bohinc, 2006, p. 330 and 331.
[116] Dolenc, p. 126 and 127.
[117] Article 240 of OZ.
[118] Cf. Third indent of Paragraph 267 of ZGD-1.
[119] Paragraph 3 of Article 263 of ZGD-1.

4.5 Statute-barring of compensation claims

Concerning time limitation (statute-barring) of launching litigation against directors, rules differ for contractual and non-contractual liability for damages. With regard to the latter, claims for damage inflicted shall become statute-barred three years after the injured party learnt of the damage and of the person that inflicted it. In each case the claim shall become statute-barred five years after the damage occurred. Compensation claims for damage that occurred through the breach of a contractual obligation shall become statute-barred after the period stipulated for the statute-barring of the obligation.[120]

The obligation to compensate shall be deemed to have fallen due at the moment the damage occurred. Therefore, it is of the utmost importance to determine when the damage occurred, as this is essential for the decision at the beginning of the five-year objective time period for compensations claims. Parties have already raised the issue of statute-barring of compensation claims in relation to claims against directors for breach of their duties and the High Court of Ljubljana has in details dealt with this issue in the case, ref. n. I Cpg 15/2009, dated as of 21.05.2009.

In this case a company concluded a sham loan agreement (dated 24 April 1998) for a substantial amount of money and advanced the funds to the borrower on 30 April 1998. The compensation claim was filed against a director on 27 October 2005 and the claimant argued that the statute-barring time period started to lapse only when the loan was due and payable, and that it was a durable unlawful event (i.e. 1 November 2000). The court held that the objective leg of the rule on statute-barring of non-contractual compensation claim became statute-barred on 1 May, 2003 (5 years after 1 May 1998). The company suffered a damage on the day of advancing the funds to the borrower and not when the loan was supposed to be due. It was not therefore necessary for the court to examine the subjective leg of the rule, but it did and it found out that the claimant should have known about the damage and the liable person at least on 5 August 1998, had it acted with the required diligence in legal transactions. The claimant further argued that the director as a defendant breached also his contractual duties under the agency agreement, but the court found that this claim has been statute-barred as well. According to the rule for statute-barring of contractual obligations, the claim shall become statute-barred after the period stipulated for the statute-barring of the obligation. Obligations under the agency agreement become statute-barred in the general five-year period. Therefore, the court has once again found out that the claim was statute-barred.

The beginning of the three-year subjective time deadline has been contested also in the High Court of Ljubljana case, ref. n. I Cp 3665/2010, dated as of 25.05.2011, where the court held that not only is it important when the claimant (as the aggrieved party) learnt of the damage and the person who inflicted it, but also when the claimant ought to have known about these circumstances. Therefore, a certain level of diligence is required also from the aggrieved party. It is the common judicial practice in Slovenia that the three-year subjective time limit begins to lapse when the aggrieved party learns or ought to have learnt of the damage and the person that inflicted it.

[120] Paragraphs 1 to 3 of Article 352 of OZ.

4.6 Insurance for directors' liability

As part of the mitigation and management of the company's risks, directors or the company may conclude the insurance agreement for insuring directors' liability[121]. It is a type of a professional insurance quite common among doctors, auditors, accountants, real estate agents, etc. Insurance of directors' liability is not as common and widespread as in some other European countries, probably also due to the negligible number of final court judgments against directors, but all big insurance companies in Slovenia offer this kind of insurance. There are two main types of directors' liability insurance (often referred to as D&O[122] liability insurance):

- Director insures his liability individually (director pays the insurance premium);
- Company concludes the insurance agreement and pays the insurance premium for the insured directors[123]. One can see that the situation may be rather unfair as the injured party (i.e. the company) is paying an insurance premium for directors, which cause damages to it. It is true, however, that creditors may be the injured parties as well. It is quite common that a company insures itself against damages arising out of claims aimed at the company.

It has to be emphasised that the insurance of directors' liability does not relieve directors from acting with due professional diligence in the best interest of the company. On the contrary, the insurance policy shall (as a rule) cover only liability cases, where directors have not acted with gross negligence or wilful misconduct. Damages arising from illegal actions of directors shall not be covered by insurance policies either. It is the interest of the company that is protected by such insurance policies and not the private (individual) interests of directors. Moreover, despite the existence of insurance policies directors remain liable with all their property, and the insurance company has recourse towards directors. In insurance against liability the injured party may demand directly from the insurance company that it reimburse the damage incurred by the party because of the development for which the insured person is liable, but no more than the amount of its obligation.[124]

4.7 Criminal liability

In addition to civil liability certain actions (or omissions) by directors may lead to their criminal liability as well. Criminal offences against the economy are regulated in Chapter 24 of KZ-1. It is beyond the scope of this report to analyse criminal offences in details, so it shall suffice to list some of them, which all represent a serious breach of the management duties with significant detrimental consequences for wider economy. The following is the non-exhaustive list of criminal offences against the economy:

- Defrauding Creditors (Art. 227 of KZ-1)
- Business Fraud (Art. 228 of KZ-1)
- Fraud in Obtaining Loans or Benefits (Art. 230 of KZ-1)
- Fraud in Securities Trading (Art. 231 of KZ-1)
- Disclosure and Unauthorised Acquisition of Trade Secrets (Art. 236 of KZ-1)
- Abuse of Insider Information (Art. 238 of KZ-1)

[121] To be legally precise, it is not directors' liability that is insured, but rather damages which directors cause as a consequence of their liability for breaching directors' duties.
[122] Directors and Officers.
[123] When a company pays the insurance premium for directors, this has tax implications since such payment is treated as a benefit in accordance with point 6, paragraph 2 of Article 39 of the Personal Income Tax Act (ZDoh-2).
[124] Paragraph 1 of Article 965 of OZ.

- Abuse of Financial Instruments Market (Art. 239 of KZ-1)
- Abuse of Position or Trust in Business Activity (Art. 240 of KZ-1)

For the sake of completeness it has to be briefly be mentioned that directors may by its actions cause a company to become liable for a criminal offence under the Liability of Legal Persons for Criminal Offences Act[125] (ZOPOKD). It is possible that a legal person shall also be liable for a criminal offence if the perpetrator is not criminally liable for the committed criminal offence or that a legal person shall be liable for a criminal offence in addition to the perpetrator. The liability of a legal person does not preclude the criminal liability of natural persons or responsible persons for committed criminal offence.[126]

[125] Article 4 (Grounds for the Liability of a Legal Person)
A legal person shall be liable for a criminal offence committed by the perpetrator in the name of, on behalf of or in favour of the legal person:
1. If the committed criminal offence means carrying out an unlawful resolution, order or endorsement of its management or supervisory bodies;
2. If its management or supervisory bodies influenced the perpetrator or enabled him to commit the criminal offence;
3. If it has at is disposal unlawfully obtained property benefit or uses objects obtained through a criminal offence;
4. If its management or supervisory bodies have omitted due supervision of the legality of the actions of employees subordinate to them.

[126] Paragraphs 1 and 2 of Article 5 of ZOPOKD.

5 DIRECTORS' DUTIES IN THE VICINITY OF INSOLVENCY[127]

5.1 Reasons for specific regulation

This section shall deal with directors' duties and liability in the event of a company's insolvency[128], but prior to a company entering into any kind of insolvency proceedings as defined in Annex A of the Council Regulation (EC) No. 1346/2000 (i.e. either bankruptcy *("stečajni postopek")* or compulsory settlement *("postopek prisilne poravnave")*). These duties operate in addition to the general duties of directors as defined in ZGD-1 and ZFPPIPP. The underpinning idea of special rules (duties) for the company and its management during the so called "twilight period" is to ensure and protect the shift in interests from mainly shareholders' interests to creditors' interests, which, upon insolvency, prevail over interests of shareholders. In addition, as soon as a company approaches insolvency, the management (as well as shareholders) loses its incentives to run a company independently and in the company's best interest, as they shall lose their jobs once the formal proceedings start. Shareholders' interests therefore become subordinated to creditors' interests so that they may be fulfilled only to the extent that they do not endanger creditors' interests to receive the payment of their claims. The common assumption for applicability of all duties outlined in this section is the insolvency of a company. The Supreme Court of the Republic of Slovenia has confirmed in its decision, ref. n. III Ips 145/2005, 14.06.2007, that being a director and not undertaking any action once a company becomes insolvent leads to director's liability to creditors.[129]

[127] The author of this report intentionally skipped any reference to duties and liability of the supervisory board members, since it is outside the scope of this paper.
[128] Insolvency shall be the situation where the debtor:
1. within a longer period of time is not able to settle all his liabilities falling due within such a period of time (continuous insolvency or illiquidity), or
2. becomes insolvent.
Unless it is proven otherwise, a debtor shall be considered continuously insolvent:
1. for a debtor who is a legal entity, sole proprietor or a private person: if he is delayed for more than two months in meeting one or more liabilities in a total amount exceeding 20 per cent of the amount of his liabilities shown in the annual report for the last business year before such liabilities became due,
2. for a debtor who is a consumer:
– if he is delayed for more than two months in meeting one or more liabilities in the total amount exceeding the amount of three times the amount of his salary, compensation or other remunerations received in a regular manner in periods not longer than two months, or
– if he is unemployed and does not receive any other regular remunerations and is delayed in meeting his liabilities for more than two months, in an amount exceeding EUR 1,000.
(3) Unless it is proven otherwise, a debtor shall be considered insolvent:
1. if the value of his assets is smaller than the sum of his liabilities (overindebtedness),
2. for a debtor who is a company: also if the loss for the current year together with the losses brought forward amounts to one half of the share capital, and such loss cannot be deducted from profit brought forward or from reserves.
(4) A debtor who is a legal entity, sole proprietor or a private person shall be considered continuously insolvent, and it cannot be proven otherwise, if he is delayed for more than three months with payment of:
- salaries to employees up to the amount of the minimum salary;
- taxes and contributions, which the employer needs to withhold and pay together with the payment of a salaries, unless the payment of taxes and contributions has been postponed in accordance with the law regulating tax procedure.
[129] See footnote 138.

5.2 Application and substance of directors' duties on the brink of insolvency

Since it is difficult (if not impossible) to define a particular point in time that would suit all companies and that would then trigger the "insolvency-based" obligations of the management, ZFPPIPP provides the unrebuttable presumption *(presumptio iuris et de jure)* that the company becomes insolvent at the moment when insolvency of the company could have been established by the management if members of the management had acted with the professional due diligence of the corporate finance and corporate governance profession.[130]

Two additional duties arise for the management of a company once it becomes insolvent, namely:

- A duty of equal treatment of creditors,[131] and
- A duty to analyse causes for insolvency and to enforce appropriate measures[132].

Equal treatment of creditors may be summarised under two prohibitions (bans):

- On the occurrence of insolvency, the company shall make no payments nor shall it assume any new obligations, with the exception of those which are essential for the continuing operation of the company[133], and
- After the company becomes insolvent, the management or other bodies of the company shall not execute any action which would contribute to the unequal treatment of creditors who are in an equal position towards the company[134].

Both prohibitions are addressed to the company. Specific actions, representing a breach of these prohibitions, are undertaken by the management board or other corporate bodies of the company, so they may be held liable for the breaches as well. The prohibitions shall remain in force until:

- The bankruptcy proceedings are initiated;
- Compulsory settlement proceedings are initiated;
- All measures of financial restructuring are implemented, and all due liabilities of the company towards its creditors are satisfied.[135]

Usually a creditor would sue a director for breach of the above duties, but in the High Court of Ljubljana case, ref. n. I Cp 4041/2010, 06.04.2011[136], the situation was just the opposite. The creditor

[130] Article 33 of ZFPPIPP.
[131] Paragraph 1 of Article 34 of ZFPPIPP.
[132] Paragraph 3 of Article 34 of ZFPPIPP.
[133] Payments deemed essential for the continuing operation of the company shall be in particular:
1. claims of creditors against the company which are priority claims in insolvency proceedings under the first paragraph of Article 21 of ZFPPIPP,
2. the running costs of a business (electricity, water rates, etc.),
3. a continuous supply of goods or services necessary for the continuing operation of the company,
4. value added tax, excise duties and other taxes and contributions which the debtor is liable to pay pursuant to regulations.
[134] An act deemed banned under the third paragraph of Article 34 shall be in particular:
1. the transfer of operations or financial transactions to another legal or natural person,
2. legal actions which would be challengeable in the case of bankruptcy proceedings under Article 271 of ZFPPIPP.
[135] Paragraph 5 of Article 34 of ZFPPIPP.
[136] It has to be mentioned that in this case the applicable statute was not ZFPPIPP but the Financial Operations of Companies Act (OJ of the Republic of Slovenia n. 54/99, ZFPPod), which regulated financial operations of companies prior to ZFPPIPP. But this does not decrease its applicability or relevance as the rules in question were very similar to the currently valid provisions.

as a claimant claimed that a director (a defendant) should have returned the supplied goods to him, whereas the Court, confirming the first instance decision and dismissing the appeal, held that during the insolvency period a defendant was bound by the strict rules on equal treatment of creditors and that the statutory rules therefore prevented him from returning the goods to the creditor.

Having become insolvent, quick actions are required by the management, as this increases the chances to remedy the company's insolvency. Therefore, the management shall within one month following the occurrence of insolvency present to the supervisory board a report on financial restructuring measures. This document shall *inter alia* include also the opinion of the management as to whether there is a probability of a minimum of 50 per cent for the successful execution of financial restructuring, the result of which would be regained liquidity and solvency of the company.[137]

Further duties and actions of the management depend on this opinion. Should it be negative, then the management shall file for bankruptcy. Should it be positive, the management must assess whether the capital increase is required or not. If it is not, then the company shall carry out financial restructuring outside the formal compulsory settlement procedure (i.e. out-of-court settlement). If the management is of the opinion that the capital increase is necessary, it shall convene the general meeting and it shall further assess the probability (if a minimum of 50 per cent exists) for the successful execution of compulsory settlement, should the capital increase fail. Depending on this opinion and the actual (non-)execution of capital increase the final result for the company may be either the initiation of a bankruptcy procedure, a compulsory settlement procedure, a liquidation procedure or out-of-court settlement.[138] Directors are under special pressure when a company is insolvent as time limits for the required actions are much shorter than under general corporate governance rules (e.g. three and five working days deadlines are common)[139].

5.3 Directors' liability in the vicinity of company's insolvency

For the avoidance of doubt, it has to be made clear that (1) ZFPPIPP regulates (separately) both directors' liability to the company and to creditors and that the former is related to directors duties in relation to financial operations of the company (outside insolvency), (2) this section shall focus on liability rules which apply to the breach of directors' duties arising once a company becomes insolvent (i.e. directors' liabilities to creditors) and (3) directors' liability analysed below only concerns the breach of directors' duties stipulated in Articles 34 to 39 of ZFPPIPP once the company enters the insolvency and does **not** apply to liability for causing the insolvency as such.[140]

It has already been mentioned that on the occurrence of insolvency creditors' interests prevail over interests of shareholders and that it is a directors' duty to act accordingly. Their failure to do so results in their non-contractual liability for damages towards creditors, as directors (drawing a distinction between directors' contractual liability for damages to the company analysed in details in section 5

[137] Paragraph 2 of Article 35 of ZFPPIPP.
[138] Cf. Articles 35 and 38 of ZFPPIPP. See also Plavšak, 2008, p. 56.
[139] Cf. Paragraph 1 of Article 38 of ZFPPIPP and paragraph 2 of Article 37 of ZFPPIPP.
[140] Therefore directors may in addition face a lawsuit for damages on the basis that they did not act with due professional dilligence and as a consequence cause the company going into insolvency. The general rules described in section 5 shall apply for assessing directors' liability. A claim for compensation of damages may be filed by a company (cf. Second paragraph of Articles 28 and 29 of ZFPPIPP and second paragraph of Article 263 of ZGD-1) as well as a creditor on behalf of the company (fourth paragraph of Article 263 of ZGD-1). Should the company already find itself in the bankruptcy procedure, the bankruptcy administrator shall act as a claimant.

above) are not in any business or contractual relationship with creditors.[141] Due to the different legal basis for claiming damages (i.e. causes of action) (non-contractual liability as opposed to contractual liability), the requirements (assumptions) which need to be proven are different than for contractual liability for damages. Rules set out in ZFPPIPP regarding non-contractual liability shall be interpreted as special rules *(lex specialis)* in relation to general non-contractual liability rules in Article 131 of OZ.

5.3.1 Assumptions for and relief from special liability for damages

The management shall be liable to creditors for any damages incurred by creditors due to their failure to achieve a full payment during bankruptcy proceedings if the company has been declared bankrupt and if the management prior to the initiation of bankruptcy proceedings:

- Has not performed acts in time referred to in Articles 35 to 39 of ZFPPIPP, or
- Has acted in conflict with the bans referred to above.[142]

There are four assumptions, which need to be fulfilled (cumulatively), should the management be held liable for damages to their creditors (under ZFPPIPP):

- A **bankruptcy procedure** has been initiated over the company.[143]
- The management **breached their obligations** under Articles 34 to 39 of ZFPPIPP, which represent unlawful undertaking. The management may have either paid or promised to pay an obligation, which was not necessary for the ordinary business operation of the company or they may have acted in a way that creditors, who were in an equal situation *vis-a-vis* the company, were treated unequally. Having failed to (timely) perform actions stipulated in Articles 35 to 38 of ZFPPIPP, directors breached a duty to analyse causes for insolvency and to enforce appropriate measures.[144]
- The management's unlawful actions must cause loss to a creditor. Loss and causation are therefore the two remaining assumptions for the liability to arise. To make proving of these two conditions easier for creditors, ZFPPIPP sets out a rebuttable presumption *(presumptio iuris)* providing that if the management does not prove otherwise, the creditor shall be deemed to have sustained a damage due to an omission or acts of the management referred to above, which amounts to the difference between the total amount of his claim and the amount up to which such claim has been settled in settlement proceedings.[145]

If the management consists of two or more members, all members shall be jointly and severally liable to creditors for damages caused.[146]

Having considered these assumptions, one can conclude that a creditor only needs to prove the management breach of duties and that at the time the breach was made, the management knew or ought to have known that the company was insolvent. The management may, on the other hand, rebut this assumption by proving that the company was not insolvent at the time of the contestable actions

[141] Plavšak, 2008, p. 59 and 65.
[142] Paragraph 1 of Article 42 of ZFPPIPP.
[143] It has been confirmed by the High Court in Ljubljana (Court order ref. n.: I Cpg 710/2010, dated as of 07.09.2010) that initiation of a bankruptcy proceeding is a procedural condition precedent to start a litigation claiming the management liability to creditors under ZFPPIPP.
[144] Cf. paragraph 1 and 3 of Article 34 of ZFPPIPP.
[145] Paragraph 2 of Article 42 of ZFPPIPP.
[146] Paragraph 3 of Article 42 of ZFPPIPP.

or that it could not have found out about the company's insolvency, even though they acted with due professional diligence.[147]

Having proven that no loss has been caused to the creditor or that the amount of loss is lower than the total presumed amount, the management gets (partially) relieved of its liability. In addition, members of the management shall be wholly or partially relieved of their liability for the damages referred to above if they can prove that the whole or a part of the damages were caused by events or the actions of other persons whose prevention, avoidance or limitation of their adverse consequences was beyond the management's capacity, despite them having acted with the professional due diligence of the corporate finance and corporate governance profession.[148]

If there is a management board with more than one member, the individual members of the management shall be relieved of their liability for the damages referred to above if they can prove one of the following reasons of acquittal:

- That they could not have carried out acts, laid down in Articles 35 to 39 of ZFPPIPP, individually and:
    - They made a proposal at the management meeting for such actions to be carried out, but were opposed by other members of the management, or
    - The member of the management who had the responsibility in the internal relation between the members of the management for the financial operations of the company failed to establish adequate expert grounds in time, or
- They have not been aware of the bans referred to in Article 34 of ZFPPIPP, or were not able to prevent them, despite having acted with the professional due diligence of the corporate finance and corporate governance profession.

5.3.2 Limitation, exclusion and enforcement of liability for damages

Individual members of the management board shall be liable to creditors for damages referred to in the first paragraph of Article 42 of ZFPPIPP, up to twice the total amount of all their remunerations for performing the function of the members of the management or supervisory board in the year, in which an act has been carried out or omitted as referred to in the first paragraph of Article 42 of ZFPPIPP; however, for the members of the management not less than:

- For a large company, EUR 150,000,
- For a medium-sized company, EUR 50,000, and
- For a small-sized company or other legal entity, EUR 20,000.[149]

The limitation of liability for damages shall not apply if the act has been carried out or omitted intentionally or by gross negligence.[150] Liability for damages dealt with in this section cannot not be excluded or limited if this would frustrate the limitation rules of liability for damages outlined above. Regulation of the management liability for damages to creditors shall not exclude the liability for damages of members of the management board under other acts.[151]

[147] Plavšak, 2008, p. 66.
[148] Paragraph 4 of Article 42 of ZFPPIPP.
[149] Paragraph 1 of Article 44 of ZFPPIPP.
[150] Please note that liability of "shadow directors" cannot be limited or capped under ZFPPIPP, because they may only act and inflict damage on a company intentionally!
[151] Paragraphs 2, 3 and 4 of Article 44 of ZFPPIPP.

6 ENFORCEMENT OF DUTIES

6.1 Claiming damages

A breach of directors' duties may result in damages suffered by (1) the company, (2) the company's creditors (including employees) or (3) shareholders. Are they all entitled to sue directors and claim damages?

6.1.1 Company

It is not the question whether a company may sue directors, but rather who decides and represents the company in the litigation (or any other proceedings) against its directors. Article 283 of ZGD-1 provides that the chairman of the supervisory board shall represent the company against (current and former)[152] members of the management board. The supervisory board shall carefully assess the performance of directors' duties and if they find a breach, they have a right and obligation to sue directors otherwise they breach their own duties. In practice it is not very realistic that the supervisory board would decide to file a lawsuit against the incumbent management board members, since their future cooperation (necessary for successful operations of the company) would be at risk. Nevertheless, even prior to recalling the management board members, a question whether the supervisory board acted in accordance with their duties, may arise. When management and supervisory board members are jointly and severally liable for damage caused by a breach of duties[153], it is not entirely clear who files a lawsuit, as the conflict of interest is unavoidable and self-evident.

Due to the potential conflict of risk between the management and the supervisory board, the general meeting shall have a role in deciding about filing a lawsuit. Should it decide to begin legal proceedings, the management is obliged to file a claim for damages within 6 months from the day the general meeting was held.[154] By analogy the general meeting shall always have a power to appoint a special representative, since it would be illogical if the body, which decides on filing a lawsuit could not be in a position to determine a person who shall represent the company.[155]

6.1.2 Creditors

Creditors may claim reimbursement of damages from directors for breach of their duties, under further condition that the company cannot pay their claims. The legal nature of the claim is not entirely clear, but the majority argues that creditors claim damages on their own behalf and not on behalf of the company *(cf. actio pro socio below)*. The claim is limited to the amount the company owes them under the underlying transaction. The statute does not say what the circumstances are under which it is deemed that the company cannot pay their claims. It is a common opinion of the experts that neither

[152] The same position has been argued in the German law. See footnote 10 in: Podgorelec, p. 983.
[153] Cf. Article 264 of ZGD-1.
[154] Reference to the management as the authorised representative in case of a litigation is rather narrow, since a lawsuit is filed against the management, the company is represented by chairman of the supervisory board.
[155] Podgorelec, p. 984.

the initiation of the insolvency proceedings nor the unsuccessful termination of the compulsory execution procedure is required as a pre-condition for filing a lawsuit. It is enough if the financial-economic situation of the company is objectively such that does not allow the payment of its due financial obligations. In most cases this situation shall coincide with the occurrence of insolvency. The legal nature of creditors' claims is still somewhat unclear, since their destiny in the eventual bankruptcy proceedings over the company is unknown.

6.1.3 Shareholders

Generally, shareholders do not have a right to sue the company's directors for damages arising out of the breach of their duties. There are three cases in our corporate law, however, when shareholders are entitled to file a lawsuit against company's directors. Please note that under Article 263 of ZGD-1 (duties and liabilities of the management board members) shareholders are not allowed to sue directors for damages. The Supreme Court in its decision ref. n. III Ips 5/2006 dated as of 03.04.2007 refused a shareholder's claim on the grounds that they lack legal interest (even if the actual interest exists), since their position would not have improved if the court heard the case and decided about its merits.

In case of liability for damages arising from the influence of third persons, shareholders may claim reimbursement for damage (if they suffered damage), irrespective of the damage that was caused to them through the damage caused to the company. This is a direct claim (not a derivative lawsuit) for damages caused to them in addition and notwithstanding the reflexive damages incurred as a result of damages suffered by the company. Please see section 5.2.4. for more details about conditions and characteristics of shareholders' claim under Article 264 of ZGD-1.

Shareholders may also launch litigation procedure against directors in cases of intra-group transactions, where a controlling company may cause damages to a dependent company. In both contractual and actual concern, any shareholder of the (dominant or controlling) company may also pursue a compensation claim of the company, but they (i.e. shareholders) may only claim payment for the company. This remedy is available to shareholders of the controlling company in both kinds of concerns and has to be distinguished from a separate claim, which shareholders have in case of an actual concern against directors of the dominant company. In the latter case, shareholders may also claim compensation for damage caused to them irrespective of the damage that was caused to them with the damage to the company. This is therefore a claim for a direct and not for a reflexive damage. They are not suing directors on company's behalf, but in their own name and on their own behalf. The compensation for damages shall belong to them and not to the company. Shareholders may sue directors on both legal bases. For details about intra-group transactions and related liability of the management, please see section 3.4.1.

ZGD-1 now also provides a right of minority shareholders to sue directors for breach of their duties on behalf of the company *(actio pro socio)*. The legal action is usually taken only after the special audit aimed at verifying whether the foundation procedures and management of individual operations of a company have been carried out.

Within six months of the general meeting, the management of the company must file a lawsuit for the compensation of damage caused by the founding shareholders in relation to the foundation or for the compensation of damage incurred by the company's individual operations as a result of the management (and supervisory) board members violating their obligations if so decided by the general meeting by simple majority. If the lawsuit shall be filed against a person who still performs the duties of a member of the management (or supervisory) board during the adoption of such decision by the general meeting, the general meeting must appoint a special representative.[156]

If the proposal for filing a lawsuit referred to in the previous paragraph has not been adopted by the general meeting or if the general meeting failed to appoint a special representative or if the management or the special representative do not act in accordance with the respective resolution adopted by the general meeting, such lawsuit can be filed, in their own name and for the account of the company, by shareholders whose holdings total not less than one tenth of the share capital or a nominal amount or the pertaining amount of the share capital totals at least 400,000 euros.[157]

The shareholders filing the lawsuit in accordance with the previous paragraph must deposit the shares with the central clearing and depository house if they have not been deposited or issued in the book-entry form and may not dispose of them until the issue of a final decision on the claim, or it shall be deemed that the lawsuit has been withdrawn. Moreover, they must be able to prove that they were really the holders of the shares at least three months prior to the general meeting, which rejected their proposal.[158]

It is not unimportant to note that the company shall deposit an advance payment for the costs of such litigation. If the company fails to deposit such advance payment, the court shall collect it *ex officio.*[159]

6.1.4 Claiming damages in one-tier management system

Should the company opt for a one-tier management system, the board of directors shall decide and then file a lawsuit (on behalf of the company) against the executive directors. In practice it is expected that the board of directors shall first dismiss executives from their office and they may do this without giving any cause. Executive directors represent the company in litigation against (former) members of the board of directors, but they need to respect instructions of the current board of directors. Concerning the competences of the general meeting, one may apply *mutatis mutandis* the position taken in the two-tier management systems. Therefore, should the general meeting decide to file a lawsuit for damages, then the board of directors is bound to start a litigation, while the general meeting may always appoint a special representative.[160]

6.2 Challenging legal actions of a debtor (in bankruptcy)

With reference to transactions concluded between directors and a company, one cannot avoid the issue of challenging the legal actions of the debtor (i.e. company), which may take place outside

[156] Such special representative shall represent the company in the proceedings before the court, which shall decide on the justification of the compensation claim, and the proceedings concerning the execution of a court ruling by which the justification of such compensation claim was decided.
[157] Paragraph 1 of Article 328 of ZGD-1.
[158] Paragraph 2 of Article 328 of ZGD-1.
[159] Cf. Paragraph 3 of Article 328 of ZGD-1 and paragraph 6 of Article 318 of ZGD-1.
[160] Podgorelec, p. 985.

bankruptcy (according to general rules included in OZ) or in bankruptcy (according to special rules in ZFPPIPP). For present purposes there is no need to go into the details of either of the regimes, so suffice it to outline the basics of the challenging regime under ZFPPIPP.

Upon the initiation of bankruptcy proceedings, the rights of creditors to challenge the debtor's legal actions under the general rules of the law of obligations concerning the challengeability of the debtor's legal actions[161] expire, and such legal actions may be challenged only pursuant to the rules laid down in ZFPPIPP.[162]

A legal action of the debtor in bankruptcy, carried out within twelve months prior to the introduction of bankruptcy proceedings, shall be challengeable:

1. if the consequences of such action are:
   - either a decrease in the net value of assets of the debtor in bankruptcy, so as to enable other creditors to receive payment for their claims in a smaller portion than if the action had not been done,
   - or a person to the benefit of whom the act has been executed, has acquired more favourable payment conditions for a claim against the debtor in bankruptcy, and
2. a person to the benefit of whom the act was executed, at the time when such act has been executed, was aware of, or should have been aware of, the fact that the debtor was insolvent.[163]

A legal action of a debtor in bankruptcy on the basis of which another person came into possession of the debtor's assets without being liable to execute its counter-fulfilment, or for a counter-fulfilment of small value, shall be challengeable irrespective of the satisfaction of the condition provided for in point 2 of the previous paragraph.[164]

Should the court find that the challenging of a legal action is justified, the legal consequences shall include annulment of legal effects of the challenged legal action. If the person to the benefit of whom the challenged legal action has been carried out, has acquired on the basis of such act fulfilment of a claim, the person shall return to the debtor in bankruptcy what he has received on the basis of the challenged legal action, and if this is no longer possible, pay financial compensation at prices valid at the time of the issue of such court decision.[165]

6.3 Disqualification of directors and other sanctions

Having in mind certain deviant insolvency cases in Slovenia, the legislator decided to introduce new provisions regarding directors' disqualifications in ZGD-1, even though the adopted solutions (being rather unique among the European countries) have been severely criticised among legal experts and scholars. The new provisions are currently not applicable, since the constitutional review of these provisions has been initiated claiming that they are in contradiction with the freedom of free economic initiative. Until a final decision, the Constitutional Court of the Republic of Slovenia has suspended the

[161] Articles 255 to 260 of OZ.
[162] Paragraph 1 of Article 270 of ZFPPIPP.
[163] Paragraph 1 of Article 271 of ZFPPIPP.
[164] Paragraph 2 of Article 271 of ZFPPIPP.
[165] Article 278 of ZFPPIPP.

implementation of the contentious articles, arguing that it would be difficult to remedy harmful consequences that could result from the implementation thereof.[166]

Article 10.a and 10.b of ZGD-1 stipulated that a person could not become a management board member (and not even a supervisory board member or a shareholder in a private company) if it has been a management (or a supervisory) board member in a company that has become insolvent or compulsorily liquidated. The same applies also to management and supervisory board members, who have performed their function in the last 2 years prior to the insolvency procedure of a company, but they no longer hold the respective function in the moment of a company's insolvency. A court may however allow such a person to perform a function of a management or a supervisory board member if the candidate proves that he has acted with due professional diligence when being a board member in the insolvent company. Moreover, there are also some very odd and highly restrictive provisions on "shareholders' disqualification" in private companies.

Not only has the law introduced restrictions on establishing, managing and supervising companies, but it has also adopted rules to disqualify the incumbent management (and supervisory board members) by mandatory dismissal and revocation of the authority to run a company.[167]

Measures under these two articles shall cease to be valid only 10 years after the completion of the insolvency proceedings upon which the measures had been undertaken. It is a duty of the Court register to *(ex officio)* monitor the compliance with these rules and to deny entry in the Court register, should there be non-compliance. Due to the temporary suspension of the respective provisions, they shall not be considered a valid law in Slovenia as of the date of issuing this report, since at the moment they cannot be applied nor enforced.

With respect to criminal liability or directors' breach of duties, please see section 5.6. The administrative sanctions do not seem to be the best solution or remedy for breaching directors' duties, so the aggrieved parties are left with civil law mechanisms before courts described in details above.

[166] Constitutional Court Decision on temporary suspension, ref. n. U-I-311/11-5, dated as of 08.12.2011.
[167] Article 10.b of ZGD-1.

7 Conflict of laws

Should there be a foreign element present in the relationship between directors and a company in terms of directors' duties and liabilities, private international law may intervene to determine the applicable law. This topic has not been researched in Slovenia yet, so please note that the following reasoning is not supported by any legal authorities or court cases. Even though this "exercise" may seem to be a rather simple task at the first glance, one shall notice that this is not the case, because there is a mixture of company's, insolvency law and civil (tort) law. Therefore, one cannot expect the same "result" (i.e. the same applicable law) in all cases where a company incurred damages as a consequence of directors' breach of duties. Please note that the Private International Law and Procedure Act (ZMZPP) does not explicitly regulate company law issues, so, in the absence of EU legislation, general rules and principles shall apply. The questions of jurisdiction of the courts and the recognition and enforcement of foreign judgments are not covered by this opinion.

7.1 Directors' liability under ZGD-1 and the conflict of laws

Should the issue of conflict of laws arise, it is highly probable that the Slovenian courts[168] shall characterise a breach of directors' liability (under Article 263 or 264 of ZGD-1) and damage caused to the company either as contractual or non-contractual liability for damages. This is also the cause of action pursued by the company (exceptionally shareholders) or creditors. Accordingly, they shall apply the relevant provision of ZMZPP and hold which law is to be used in a particular case. It is not expected that different duties are to be treated differently in terms of conflict of laws rules.

Unless otherwise provided for by ZMZPP or an international treaty, the law chosen by the parties shall be used for contracts. The preference of the parties with regard to the law may be expressed explicitly, or must be unequivocally clear from contractual provisions or other circumstances. The validity of the contract on the choice of law shall be judged under the chosen law.[169] If the parties have not chosen the law which is to be used, then the law with which the relation has the closest ties shall be used. Unless special circumstances of the case instruct that another law must be used, it shall be considered that the closest ties exist with the law of the country of permanent residence, or of the head office of that one of the parties which is obliged to carry out the task specific to the particular contract.[170] In practice it is very common that the company concludes some kind of contract with its directors and at the end provisions the applicable law is determined. The most common foreign element in the director-company relationship is a foreign nationality of directors. In the great majority of most, if not all, cases the chosen law is the law of the Republic of Slovenia. If the parties do not choose the applicable law, then the Slovenian law shall (most probably) apply, as having the closest ties with the matter. Please note that the parties may pick the law only with regard to their mutual rights and obligations and they may not interfere in the law on the basic status corporation rules of the foundation and operations of companies. This law is *ius cogens* and applicable to all companies registered in the Republic of Slovenia.

[168] *"A court in the Republic of Slovenia shall have exclusive jurisdiction in disputes which arise during the founding or cessation of or status changes in a company, other legal entity or association of natural persons or legal entities and in disputes over the validity of decisions by their bodies, if the head office of the company, other legal entity or association, is in the Republic of Slovenia."* (Article 60 of ZMZPP).
[169] Article 19 of ZMZPP.
[170] Article 20 of ZMZPP.

There is a general rule in Article 17 of ZMZPP that the law of the country to which a legal entity belongs shall be used in matters concerning the legal status of this entity. To whom a legal entity belongs shall be determined under the law of the country in which this entity was founded. If the actual head office of a legal entity is in a country other than the country in which it was founded, and under the law of this other country also belongs to it, it shall be considered that it belongs to this other country. It does not seem that directors' liability for a breach of their duties and potential claiming of damages is included in this conflict of law rule. Nevertheless, directors' duties themselves may be governed by this rule (incorporation theory is primary, but if certain conditions are met, it may be substituted by the real seat theory).

If a director is in an employment relationship with the company, the law of the country where a contractual worker usually works shall be used for employment contracts. It shall not be considered that the worker usually works in a certain country, if he is working there temporarily. If a contractual worker does not usually work in one country only, then the law of the country of the employer's head office or permanent residence shall be used. The parties shall not be able with an agreement on the law of choice to preclude the application of compulsory provisions on protection of workers' rights, contained in the law of the country which would have been used if the parties had not chosen the law.[171] It is not very probable that this provision shall apply as the management usually enters into different (managerial) contracts with the company.

For non-contractual liability for damages, the law of the place where the action was committed shall be used. If it is more favourable for the injured party, the law of the place where the consequence occurred shall be used instead, but only if the perpetrator could have foreseen or ought to have foreseen the location where the consequence occurred. If the law so determined does not have a close connection to the relation, and a connection with some other law obviously exists instead, then that law shall be used.[172]

Concerning the applicability of the Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I), *"questions governed by the law of companies and other bodies, corporate or unincorporated, such as the creation, by registration or otherwise, legal capacity, internal organisation or winding-up of companies and other bodies, corporate or unincorporated, and the personal liability of officers and members as such for the obligations of the company or body"* are excluded from the scope of application of the respective regulation. A similar exclusion provision is contained in the Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II).[173] Assuming that the court characterises the cause of action either as a breach and liability of contractual or non-contractual obligations under ZGD-1 (i.e. companies law), then it is possible that taking into account the scope of application, the two regulations (Rome I and Rome II) cannot be applied.

[171] Article 21 of ZMZPP.
[172] Article 30 of ZMZPP.
[173] *"non-contractual obligations arising out of the law of companies and other bodies corporate or unincorporated regarding matters such as the creation, by registration or otherwise, legal capacity, internal organisation or winding-up of companies and other bodies corporate or unincorporated, the personal liability of officers and members as such for the obligations of the company or body and the personal liability of auditors to a company or to its members in the statutory audits of accounting documents;"* (Article II, 2(d) of the Rome II Regulation)

7.2 Directors' liability in the "vicinity of insolvency" under ZFPPIPP and the conflict of laws

Considering directors' duties and liability in the event of insolvency, but prior to initiating any of the insolvency proceedings, one can assume the same distinction between contractual liability for damages (in relation between directors and a company) and non-contractual liability for damages (in relation between directors and company's creditors). In this case the same conflict of law rules as described above shall apply. Even if the international element is present, the Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings shall not apply, because its scope of application is limited to collective insolvency proceedings as listed in Annex A to the regulation. This report is however limited to directors' duties and liabilities prior to initiation of any collective insolvency proceedings.

7.3 Conclusion

In the absence of any authority in this particular field, we may conclude that the liability of directors for breach of their duties can be characterised as either contractual or non-contractual liability for damages. The existing court decisions (without any international element) support this view.[174] Once the legal characterisation of the case is finished, the appropriate conflict of laws rule shall be applied and in the vast majority of cases the Slovenian law shall apply. In fact, it is very unlikely that the Slovenian courts shall apply a law other than the law of the Republic of Slovenia when adjudicating cases of directors' liability. The primary rule for the status of companies is the incorporation theory, which can be substituted by the real seat theory, if the main centre of the company's operations is in another state and if this state applies the real seat theory.

[174] Cf. Judgment of the High Court of Ljubljana, ref. n. I Cpg 15/2009, dated as of 21.05.2009 and judgment of the Supreme Court, ref. n. III Ips 86/2004, dated as of 24.05.2005.

LSE Enterprise

DIRECTORS' DUTIES AND LIABILITY IN SPAIN

Initial author: Juan Carlos González Fernández

CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in Spain

Under the Spanish legal system, the distinction between general private law (or civil law) and commercial law is still alive, at least on the books, since the Commercial Code and other laws contain rules about contract types that are also subject to rules in the Civil Code. As an example, the contractual agreement to create a company may be governed either by the Civil Code or the Commercial Code. The main difference between both types is the objective or purpose of the company. Companies governed by the Civil Code may take on any form so long as they have a non-commercial purpose, whereas companies governed by the Commercial Code must take on certain forms and they must have a commercial purpose. This is still true regarding partnerships. For private or public limited companies the rule is that they are commercial entities in any case, notwithstanding the purpose – commercial or non-commercial – that they pursue. These company types are regulated by the *Ley de Sociedades de Capital* (LSC), the Spanish Corporations Act.

Article 122 of the Commercial Code provides for four different types of commercial companies as follows:

- General partnership: this kind of company is personal in nature. The partners are jointly and severally liable to the full extent of their personal assets for partnership debts. The company has a collective name and is managed collectively. Its main regime is provided for by the Commercial Code. It is the "commercial" counterpart of the general partnership regulated in the Civil Code.
- Limited partnership company or limited partnership with shares: the company is formed by two different types of partner. General partners are jointly and severally liable with their personal assets. Limited partners pay up capital; their liability is limited to the amount contributed. Some limited partnerships may have capital divided into shares. The law always requires there to be at least one general partner. The legislative regime of the limited partnership with shares is provided for by the new Corporation Act (LSC). This law has codified the rules relating to Public Limited Companies and Private Limited Companies in a single text.
- Public limited company: the company's capital is divided into shares, which are owned by shareholders who are only liable for company debts to the extent of their contribution. The minimum required capital is 60,000 Euro.
- Private limited company: its capital is divided into participations (different from shares, for example, because they cannot be traded on stock exchanges), owned by partners who are not personally liable for the company's debts. The capital of the private limited company shall be at least 3,000 Euro.

1.2 Corporate landscape in Spain

The table below shows the number of companies created under Spanish law and their subscribed and paid-up capital. Data are from the Central Mercantile Register.

		Public LC			*Private LC*			*Others*	
Year	number	subscribed	paid up	number	subscribed	paid up	number	subscribed	paid up
2006	2029	2.668.590.591,73	77,90 %	141.830	15.505.267.424,87	100,00 %	4.789	687.023.818,24	81,45 %
2007	1904	3.823.566.240,46	66,02 %	138.879	10.439.576.243,98	100,00 %	4.810	1.093.487.625,83	34,39 %
2008	1283	2.002.674.898,08	77,57 %	99.473	6.132.789.951,22	100,00 %	6.485	292.578.647,30	84,61 %
2009	753	721.653.384,92	66,52 %	74.333	3.672.481.954,37	100,00 %	4.671	331.361.413,42	81,32 %
2010	737	1.025.695.242,33	86,37 %	75.885	6.053.509.382,82	100,00 %	3.772	1.087.858.049,81	99,21 %
2011	653	17.529.230.108,32	98,82 %	81.027	3.777.089.104,48	100,00 %	3.274	152.354.619,22	98,48 %

Regarding listed companies, according to the data of the BME,[1] the number of companies in 2011 was 3,274 and the capitalisation of the Spanish stock market was slightly above 950,000 million Euro. Among the largest companies on the Spanish Stock Exchange are formerly state-owned companies such as Telefónica or Repsol-YPF.

1.3 The board of a Spanish company

According to Article 23(e)[2] LSC, Spanish limited companies have a one-tier board system. A general statutory right for employees to have representation on the board does not exist. Labour law provides for trade union representation in the firm, but these committees are only responsible for supervising the employees' working conditions and several other employment-related matters**.** The right to elect employee representatives begins in enterprises with more than ten employees. However, they may be elected in enterprises with as few as six people if a majority of the employees determines this. In enterprises with fewer than fifty employees, the representatives are called employee delegates. In enterprises with fifty or more employees, the representatives are elected as members of a works council.[3] The tasks of the works council include, among other issues,[4] information, consultation, and monitoring of the application of certain labour regulations. However, the works council has no power to direct management to adopt particular business decisions.

[1] Bolsas y Mercados Españoles (BME) is the operator of all stock markets and financial systems in Spain. BME has been a listed company since 14 July 2006 and an IBEX 35 constituent company since July 2007.
[2] Article 23: The by-laws governing corporate enterprises shall contain the following items:
[…]
e) in limited liability companies, the governance arrangements; in public limited companies, the structure of the body to which company governance is entrusted;
The by-laws shall also specify the number of directors or at least the minimum and maximum number thereof, as well as their term of office and the remuneration scheme, as appropriate; and in limited partnerships, the identity of the general partners.
[3] See Article 60 and followings of the Employees' Statute.
[4] See Article 64 of the Employees' Statute.

2 The concept of ‘company director’ in Spain

2.1 De iure director

2.1.1 Requirements to become a *de iure* director

The function of representation is carried out by the director/s. Article 210 LSC sets forth the different types of managerial structure concerning directors. The administration may be entrusted to a sole director, several directors acting jointly or jointly and severally, or a board of directors. In the specific case of public-limited liability companies where the administration is entrusted to two directors, they have to act jointly, and where it is entrusted to more than two directors, a board of directors must be formed. A board of directors is mandatory for listed companies. When the by-laws specify only the minimum and maximum number of directors, the general meeting shall determine the exact number, subject only to the limitations provided by law (Article 211 LSC). Nevertheless, the legal approach to the board of directors cannot be understood without the recommendations of the corporate governance codes, at least for listed companies. In fact, the codes, and not the law, have developed the functions and the structure of the board of directors, and they are, at least formally, complied with by a large majority of listed firms. First, many recommendations concern the organisation and the structure of the board. The recommended size is no fewer than five and no more than fifteen members. Boards are also encouraged to meet with a certain frequency and board members have to attend the meetings. Boards are composed of three kinds of directors: executive directors, proprietary directors (representing the capital ownership), and independent directors. At least one third of the board members must satisfy the requirements for independence and represent the free-flow. Second, the board of directors has a general oversight function. The work of the board is organised through delegated committees: on the one hand, the executive committee, and on the other hand, the supervision and control committees. Independent directors should compose a majority of the nomination and remuneration committees.

If a board of directors is formed (with at least three directors), there must be proportional representation. Article 243 LSC establishes that in public limited companies shareholders that group together voluntarily are entitled to designate directors in the proportion of the grouped shares to the company’s total capital, rounding any fractions. When this power is exercised, the shares so grouped are excluded from taking part in the election of the remaining members of the board. Nevertheless, in practice the so-called proportional representation is only applied rarely. In part, this is because it is not easy for dispersed minority shareholders to group together, except if they hold a significant share. But, mostly the reason is that the system has not received support in the academic literature and is not welcomed by majority shareholders. Thus, different legal strategies have been put in place to reduce the actual level of enforcement of the system, for example by relying on the general practice of appointment of board members by co-optation. This practice effectively removes the right of the minority, which is only available when there is a vacant position.

Recently, Article 224 LSC has provided for a new argument against minority directors. Some judicial rulings have stated that if the shareholder relying on proportional representation is a "competitor", any director appointed by her through said mechanism may be dismissed right away and at any time by the general meeting (that is, by the controlling shareholders), even if the appointed director is substantively independent from the appointing shareholder.

2.1.2 Who can be *de iure* director

According to Article 212 LSC, a legal or natural person may become a director. In the former case, the legal person must appoint a natural person to exercise the functions of a director. Unless required in the corporate bylaws, directors need not be shareholders.

Generally speaking, directors must have legal capacity to enter into contracts without any limitation. Pursuant to Article 213 LSC, relating to prohibitions, persons may not serve as directors if:

- they do not enjoy full legal capacity, e.g. in the case of non-emancipated minors and judicially incapacitated persons;
- they are persons disqualified according to the Spanish Insolvency Act. This applies to persons who are convicted of any manner of falsehood or of crimes against freedom, property, socio-economic order, public safety, or the administration of justice; or
- they have a current position which is incompatible with commercial activity (e.g. civil servants, judges or other persons with legal incompatibilities).

The power to appoint directors is vested in the general meeting subject only to the exemptions provided by law. The appointment is effective upon the candidate's acceptance of the position (Article 214 LSC).

Upon acceptance by the directors concerned, application shall be made for entry of their appointment in the Mercantile Registry (within ten days of acceptance), specifying in the application the identity of the appointees and, for directors vested with the power to represent the company, whether they can act singly or are bound to do so jointly (Article 215 LSC).

2.2 *De facto* and shadow directors

2.2.1 De facto directors

The concept of *de facto* director was recognised first by criminal law. Subsequently, by means of Law 26/2003, it was transferred to the consolidated text of the Public Limited Companies Law, which was the basis for the LSC in 2010. Article 236 LSC[5] seems[6] to establish the same liability for *de iure* and *de facto* directors; however, it lacks a definition of *de facto* director.

[5] Article 236.1 stipulates: "*De iure* or *de facto* directors shall be liable to the company or its shareholders and creditors for any damage caused by their acts or omissions where contrary to law or the by-laws or by any action or omission performed in breach of the duties inherent to their position".

[6] The majority of scholars argue that *de iure* and *de facto* directors have the same liability. However, Guillermo Guerra Martin disagrees and shares the opinion of the Supreme Courts in the judgment of 30 July 2001, in which the Court held that *de facto* directors are only liable for external acts in relation to third parties, but not internal acts that require the powers of *de iure* directors and where *de iure* directors are liable.

The concept has evolved over the last decades by means of case law and academic commentary. Until the 1980s, following a formal approach, a *de facto* director referred to someone who continued to act as a director after his office had been terminated. The concept was established as a way to allow the continuation of the business activity in some cases. From the 1990s, as in other jurisdictions, the term evolved to define the person who acts as a director but is not a *de iure* director due to the termination of his office or simply because he never held the position. The aim of the change is to protect the appearance of legality of certain acts and allocate liability to persons who act as if they were *de iure* directors, without formally holding the office. The most evident cases are those of invalid appointments (formal appointments with procedural or consent defects causing invalidity), or appointments already expired.[7] Other situations, such as those of persons who have never held the position of director are rare and confined to closed companies.

Some scholars refer to the following points as conditions to be a *de facto* director:

- The activity of director must be carried out in a continuous manner;
- independently;
- with the knowledge of the shareholders;
- there must be a real administration; and
- for some scholars, the powers must be exercised in relation to third parties. This is the most controversial requirement.[8]

2.2.2 Shadow directors

There is no reference in the Act to the concept of "shadow director". However, the concept is known in the literature and was developed on the basis of UK law. A shadow director is understood to be a person who does not exercise the power of a *de iure* director but whose instructions are complied with by the directors.

Depending on a broader or narrower definition of *de facto* director, shadow directors may or may not be included in the definition of *de facto* director. The most promising solution is to argue that both shadow and *de facto* directors are expressions of the same underlying idea.[9] In this sense, a *de facto* director would be a person who exercises the powers of a *de iure* director by either replacing the *de iure* director or influencing his decisions. Because "shadow director" is not a working legal concept, the option of including the shadow director in a wider notion of *de facto director* is the only available mechanism to hold the shadow director (mostly, the controlling shareholder) liable.

An alternative approach would consider that the notion of *de facto director* was developed to protect third parties who rationally rely on contracting with the corporation. Therefore, a rigorous and dogmatic conception of *de facto director* cannot include the shadow director. Instead, the action of a shadow director may be qualified as a legal fraud (*fraude de ley*). The consequence would be the application of directors' duties and liability of the LSC to the *de facto* director.[10] Therefore, this is another way to arrive at the same result, namely that the duties and liability under the LSC apply to shadow directors.

[7] STS 7-V-07; STS 26-V-06; 28-IV-06.
[8] Guillermo Guerra Martín, *La responsabilidad de los administradores de sociedades de capital* (La Ley, 2011) 56; Jose Luis Díaz Echegaray, *El administrador de hecho de las sociedades* (Aranzadi, 2002) 108.
[9] Quijano, la responsabilidad de los administradores de la sociedad anónima (1985) 351.
[10] Article 6.4 of the Civil Code: "Acts performed pursuant to the text of a legal rule, which pursue a result forbidden by the legal system or contrary thereto shall be considered to be in fraud of the law and shall not prevent the due application of the rule which they purported to avoid."

But technically this may be imperfect. It may not qualify exactly as *fraude de ley*, and to some extent, it refuses to realise that controlling shareholders have *de facto* control rights.

2.3 Directors in groups of companies.

One of the biggest loopholes in Spanish corporate law is the lack of regulation of groups of companies. Nevertheless, it is not the case that directors' duties and liability do not play any role in the regulation of groups of companies. Rather, in groups of companies fiduciary duties are necessary to protect minority shareholders at the subsidiary level. Groups of companies have not attracted the attention of Spanish academics and the problem is still largely in search of answers.

Article 42.1 of the Commercial Code defines groups of companies as follows:

> A group exists when a company holds, or may hold, directly or indirectly, the control over one or several others. In particular, there shall be presumed to be control when a company, which shall be classified as controlling, is in a relation with another company, which shall be classified as dependent, in which any of the following situations arise:
>
> a) It holds the majority of the voting rights;
>
> b) It has the power to appoint or dismiss the majority of the members of the governing body;
>
> c) It may, by virtue of agreements entered into with third parties, dispose of the majority of the voting rights;
>
> d) It has used its votes to appoint the majority of the members of the governing body who hold office at the moment when the consolidated accounts must be drawn up and during the two business years immediately preceding.

As we can see, the concept of a group is related to the idea of control, which usually leads to unity of direction. Given that specific rules are lacking, the only way to make directors liable is to recognise the control powers of the directors of the parent company in the management of the subsidiaries. There is a trade-off between the interest of the individual company and the group interest. Two solutions may be considered. First, it may be held that the system of fiduciary duties of corporate law also finds application in the context of groups. Second, the only existing way to make the parent company or its directors liable is the concept of *de facto director*, and the loyalty duties of the controlling shareholder.[11] The problem is again that fiduciary duties of controlling shareholders are surprisingly underdeveloped.[12]

In this context, some scholars have identified a significant loophole in the case of a controlling company making decisions that are harmful to one of the controlled companies, its creditors and shareholders, but beneficial to the rest of the group. There is no specific provision to address this

[11] Cándido Paz-Ares, in Uria/Menendez, Curso de derecho mercantil, I., (2006), pp. 1484-1487.

[12] According to some scholars, this coordination or unity of direction has nothing to do with the concept of *de facto* director. They consider that in order to characterize the controlling company as a *de facto* director, it is necessary to show that the controlling company goes beyond complying with the strategy and guidelines to achieve group objectives. Rather, it must administer the controlled company in a continuous, transparent, public and effective manner, Guillermo Guerra Martín, *La responsabilidad de los administradores de sociedades de capital* (La Ley, 2011) 60.

issue and the theories of *de facto* and shadow director do not seem to have been applied, or to receive relevant support for their application.

3 THE SCOPE OF DIRECTORS' DUTIES UNDER SPANISH LAW

3.1 Types of directors' duties

The directors or board of directors are vested with wide powers to perform their functions. The company law provides for several specific duties (in relation to the financial statements, attendance at general meetings etc.) that can be expanded by private ordering (in the by-laws, the appointment agreement or the board of directors' rules of procedure). Nevertheless, it is difficult to regulate all duties in specific cases due to the complexity of functions and obligations that the directors must fulfill. For this reason, the law provides for general duties regarding the way directors must behave and discharge their functions.

The legislation currently in force can be found in the LSC. The Act has extended directors' duties of public limited liability companies to limited companies.

Articles 225-232 LSC define the following duties (they are cumulative):

- Due diligence
- Loyalty
- Prohibition to use the company name or invoke the directorship
- Prohibition to take advantage of business opportunities
- Conflict of interest
- Prohibition of competition
- Secrecy

Likewise, Article 514 LSC, which was formerly included in the *Ley de Mercado de Valores* (Securities Act), concerns directors' voting rights and public request for representation.

Most of the literature points out that the LSC regulates the following general duties: a general standard of due diligence; a general standard of the duty of loyalty and its most common manifestations (prohibition to use the company name or invoke directorship, prohibition to take advantage of business opportunities, conflict of interest and prohibition of competition); and the directors' duties in listed companies (some of them are also regulated in the Securities Act).

3.1.1 Article 225: Due diligence

Article 225 states:

1. Directors shall perform their duties with the diligence of an orderly businessman.
2. Each director shall remain diligently abreast of the company's progress.

As far as the provision refers to the orderly businessman (duty of care), it is necessary to stress that it seeks to establish an objective and general standard of conduct, since we have seen above that it is impossible to regulate every single type of situation that a director may face. Businessmen are not obliged to achieve a specified result, but they are required to use the adequate means. This reflects the consideration of the lawmaker that every business runs its own risks. As a corollary of this duty, the literature interprets some judgments[13] as accepting the application of the business judgment rule. Indeed, some judgments expressly mention the business judgment rule as a common law concept that prevents the *ex post* examination of the directors' decisions when the director acts in the best interest of the corporation, unless the decision is irrational or technical mistakes can be shown.[14]

Furthermore, some scholars argue that the diligence required is that of a professional and not that of a diligent individual. The degree of diligence must be adapted depending on the individual circumstances, such as the type of business activity, whether or not the company is listed, or the position of the defendant director on the board of directors (executive or non-executive).

Although standards have to be specified on an after-the-fact basis, Article 225.2 LSC provides for a specific case of the duty of care, i.e. the duty to be informed. This duty is the result of the Spanish corporate governance reports (Olivencia in 1998 and Aldama in 2003), scholarly contributions, and the movement to reform the corporate governance of listed companies according to US-American standards and develop different duties in order to provide a detailed legal framework for the directors.

Finally, in relation to the duty of care, the LSC and case law provide for some specific duties. Breach of these duties will also lead to directors' liability:

- Article 32.1 LSC: the founding partners or shareholders and directors must submit the deed of incorporation for entry in the Mercantile Registry within two months of the date of execution thereof and shall be held jointly and severally liable for any damages caused by failure to comply with this obligation.
- The directors must take special care to ensure that the conditions of public-limited liability companies to acquire their own shares are respected (Art. 146 LSC).
- Duty of attendance at general meetings (Art. 180 LSC) and to comply with the quorum for board of directors' meetings (Art. 247 LSC).
- Article 168 LSC: directors must convene a general meeting when so requested by one or several partners or shareholders representing at least five per cent of the share capital.
- Duty to continue to act as a director and administer the company after the termination of office if such termination can lead to the paralysis of the board of directors (RDGRN, 22nd June, 1994).
- Article 253.2 LSC: the financial statements and management report must be signed by all directors. If any signature is missing, all the documents shall contain a mention thereof and an explicit explanation.
- Article 313 LSC: After the decision to increase the share capital is implemented, the directors must redraft the by-laws to reflect the new amount. They shall be understood to be empowered to do so by virtue of the decision regarding the capital increase.

[13] Jesús Alfaro refers to the judgment of the Audiencia Provincial of Madrid, number 168/2007, 13 September 2007.
[14] Judgment of the Audiencia Provincial of Pontevedra, number 50/2008, 24 January 2008.

3.1.2 Article 226: Loyalty

Article 226 LSC states:

> Directors shall act as loyal representatives in defence of the corporate interest, understood to be the interest of the company, and shall perform any duties laid down by the legislation or the by-laws.

In case of a conflict between the interests of the director and those of the corporation, the director must put the corporation's interests ahead of his own. The principal objective is to align the interests of the company and the directors.

The duty is based on the concept of loyal representation. This is a standard of conduct whose meaning has been developed by Articles 226-231 LSC in accordance with recommendations in the corporate governance reports (mainly the Aldama report), whose conclusions led to the reform of the Public Limited Companies Law in 2003 (Law 26/2003 on Transparency). The new articles aim to exemplify and typify paradigmatic conflicts of interests and increase legal certainty for directors (and also for enforcers), but they do not constitute an exhaustive list.

A very important issue is the reference to the corporate interest. The so called "corporate interest" is a general clause intended to guide the conduct of the decision-makers of the company (directors, but also the general meeting of shareholders). It is an open concept, whose purpose is to provide a framework for dealing with unanticipated conflicts and problems. On the one hand, it refers to the traditional prohibition to pursue personal advantages causing harm to the corporation. In addition, the general clause points to the prohibition to obtain benefits at the expense of other shareholders. However, the concept is underdeveloped and underenforced, particularly with respect to this second implication, and frequently the interest of the corporation is interpreted in line with the interest of the (majority) shareholders. In this sense, the interest of the corporation refers not only to the interest of the company, but also to the common interest of the shareholders. This problematic situation needs to be addressed, and it is fair to say that courts are not the only ones to blame. Academics and law makers have failed to provide further reflections. In fact, case law and commentators have narrowly interpreted the article as reflecting the shareholder versus stakeholder discussion. There were two possible interpretations: a) the corporate interest must be understood as the shareholders' interest; or b) the corporate interest must encompass not only the shareholders' interest, but also the interest of the company itself and other stakeholders such as creditors and employees. As discussed in more detail below, the Supreme Court has ruled in favour of the first interpretation.[15]

3.1.3 Article 227: Prohibition to use the company name or invoke directorship

Article 227 LSC states:

> Directors shall not use the name of the company nor invoke their capacity as directors thereof when conducting operations for their own account or for the account of affiliates.[16]

[15] See n 21 below.
[16] Article 231 CEA:
1. For the purposes of the preceding articles, directors' affiliates shall be the persons listed below:
a) The director's spouse or persons with an analogous relationship
b) The director's or his/her spouse's parents, children and siblings
c) The spouses of the director's parents, children and siblings

As we have said above, this article is a specification of the general duty of loyalty. Directors can only use the name of the company and their status as director to pursue the interests of the company. When this is not the case, they breach the duty. However, the directors are only liable if the company has suffered a loss (Art. 236 LSC). This prohibition has its most natural *habitat* in close corporations, where the risk of confusion created by the use of the company name is more significant. In fact, this prohibition is more related to the problem of the *falsus procurator* than the conflicts of interest between directors and the company.

Finally, it is necessary to note that the use of the name of the company also refers to the use of the name of the group of companies if it is a subsidiary.

3.1.4 Article 228: Prohibition to take advantage of business opportunities

Article 228 LSC states:

> Directors may not invest, for their own benefit or the benefit of affiliates, in any operations relating to company assets of which they may become aware by reason of their position, when such investment or operation is offered to the company or the company has an interest therein, unless the company has ruled out the investment or operation in a decision not influenced by the director.

This duty has its origins in the US corporate opportunities doctrine and was introduced into Spanish law by the Aldama and Olivencia reports. According to this duty, directors of a company must not take for themselves any business opportunity that could benefit the corporation. It is a typical conflict of interest rule. The director is obliged to communicate the conflicting situation to the company (pursuant to Arts. 226 and 229 LSC), and the company may authorise the transaction. The director involved must refrain from taking part in the debate and the decision.

3.1.5 Article 229: Conflict of interest

Article 229 LSC states:

> 1. Directors shall inform the board of directors or, in the absence thereof, the other directors or in the event of a sole director, the general meeting, of any situation that may involve a conflict between their own and the company's interests. Directors in such situations shall refrain from taking part in decisions relative to the operation around which the conflict has arisen.
>
> 2. Furthermore, directors shall inform the company of the direct or indirect stake they and their affiliates as defined in Article 231 may have in a company with the same, analogous or similar corporate purpose, and the positions or duties they perform therein.
>
> 3. The conflicts of interest described in the preceding paragraphs shall be included in the notes to the financial statements.

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d) Companies with which the director, directly or by proxy, is affiliated in any of the manners described in article 42, paragraph one of the commercial code.
2. When directors are bodies corporate, their affiliates shall be the persons listed below:
a) Partners or shareholders who are affiliated with such body corporate in any of the manners described in article 42, paragraph one of the commercial code
b) *De iure* or *de facto* directors, liquidators, and attorneys with general powers of attorney in the company's body corporate director
c) Companies forming part of the same group and their partners or shareholders
d) Persons who, pursuant to the provisions of the preceding paragraph, qualify as affiliates in respect of the above body corporate's representative.

The origin of this provision can also be traced back to the Aldama and Olivencia reports. The article provides for three duties: two of them for the directors (duty of disclosure and refraining from taking part in some decisions) and the third for the company as a whole (duty of publicity).

This article represents a turn in the legal treatment of the duties of loyalty. Previously, the legal strategy was the prohibition of any conflict of interest. Now, as in other jurisdictions, it is assumed that conflicts of interest are a natural consequence of exerting control and do not necessarily result in a loss for the company. Therefore, instead of prohibiting any conflicting transaction unless the company authorises it, the new approach consists in permitting any conflicting transaction unless it is unfair. The conflict of interest is defined in a very broad way, so it can encompass situations of self-dealing and third-party transactions, but also conflicts of interest affecting the internal decision-making processes of the corporation, such as using internal powers to seek prerogatives and benefits or to entrench themselves in a controlling positions. However, the literature has focused only on the external aspect, ignoring the implications of the internal dimension of the conflicts of interest, arguing that this situation does not harm the company.[17] In sum, the regulation of conflicts of interest is underdeveloped by the academic literature. It is confined to conflict transactions with third parties, there are no clear ways to assert the fairness of the transaction, and the interests of the minority shareholders are not protected when they, and not the company, suffer a loss.

This new approach has driven a wedge between two different ways of understanding the duty of loyalty. The problem is that the new rules have not been accompanied by a reform of the old ones. A good example are articles 224.2 and 230.3 LSC (article 132.2 of the former Consolidated Text of the Public Limited Companies Law)**,** which state that the directors who hold an interest in another company that clashes with the company's interests shall be dismissed by a decision adopted by the general meeting at the behest of any shareholder.

3.1.6 Article 230: Prohibition of competition

Article 230 LSC states:

> 1. Directors may not, for their own account or the account of others, engage in a business that is the same as or analogous or supplementary to the business constituting the corporate purpose, without explicit authorisation from the general meeting. To obtain such authorisation they shall provide the information described in the preceding article.
>
> 2. In limited liability companies, any partner may request the commercial court with jurisdiction in the place where the registered office is located to remove any director in breach of the above prohibition.
>
> 3. In public limited liability companies, at the behest of any shareholder, the general meeting shall decide on the dismissal of directors who are also directors of a competing company.

This is the last explicit duty that forms part of the general duty of loyalty. It is important to note that such prohibition was unknown to the former Consolidated Text of the Public Limited Companies Law.

The previous Article 127.ter.4º imposed only an obligation to disclose the conflict to the company (now laid down in Article 229.2 LSC), but the duty existed in the Private Limited Companies Act (Article 65.1). The new law had the purpose of merging both laws into a single rule for all kinds of limited

[17] V. Ribas, Art. 229, Comentario a la ley de sociedades de capital, Tomo I., (2011), 1636-1652.

companies, but without amendments. However, although the article distinguishes between limited liability companies and public limited liability companies, the first paragraph, which keeps the wording of the repealed Article 65.1 of the Private Limited Companies Act, is common to both types of company.

As we have mentioned before, this article generates some problems of interpretation in relation to Article 132.2 of the former Consolidated Text of the Public Limited Companies Law. The Supreme Court established that the general meeting shall dismiss a director if it considers that there is a conflict of interest. If it does not dismiss the director, the agreement could be declared void.[18] It is interesting to note that this doctrine has only been enforced to remove directors appointed by the minority, but not regarding other cases, such as interlocking directors appointed by the controlling shareholders.

With the new Act, former Article 132 has been divided into two articles: 224 LSC and 230 LSC. Reading Article 230.3, it can be concluded that the dismissal of the implicated director is within the discretion of the general meeting.

3.1.7 Article 232: Secrecy

Article 232 LSC states:

> 1. Directors, even after having left office, shall keep all confidential information secret, and shall be bound to honour the non-public nature of information, data, reports or factual antecedents of which they may become aware by reason of their position and refrain from their disclosure to third parties or the public at large where the consequences may be detrimental to the corporate interest.
>
> 2. The duty described in the preceding paragraph shall not apply to cases in which, pursuant to the legislation, such information may be conveyed or disclosed to third parties or where, as appropriate, it is required by or must be sent to the respective supervisory authorities, in which case the information shall be conveyed in accordance with legal provisions.
>
> 3. When the director is a legal entity, the duty of secrecy shall be incumbent upon its representative, without prejudice to compliance with the obligation to report thereto.

The duty of secrecy is an expression of the duty of loyalty and is one of the duties traditionally recognised by Spanish law. The Law of Transparency of 2003 developed it further. The idea was to reinforce the monitoring function of the board of directors. The executive directors are obliged to provide information about the company to the outside directors: Without information, the monitoring and supervising task cannot be discharged. As a counterpart, the duty to keep confidential information is expanded. It also applies to legal entities that are directors (Article 232.3 LSC).

A difference to other provisions is the moment when the duty ceases to exist. As opposed to other duties, the director continues to be bound by the duty of secrecy even after his dismissal or retirement. There is no provision stating the duration of the duty, but scholars argue that it should end when the consequences of disclosure are no longer detrimental to the company or the information can be disclosed.[19]

[18] Judgment of the Supreme Court (Sala de lo Civil), number 653/2008, 2 July 2008.
[19] Guillermo Guerra Martín, *La responsabilidad de los administradores de sociedades de capital* (La Ley, 2011) 39.

The duty of secrecy refers to confidential information. The legislator tried to clarify the concept by stating that it encompasses data, reports or factual information of which the director became aware due to his position. Some scholars and case law have explained that confidential information is any kind of information relating to the company (industrial, commercial, financial etc.) that is important for the company's business operations and is kept secret to avoid a loss for the company.[20]

Article 232.2 LSC contains an exemption from the duty of secrecy. It provides for cases such as the disclosure of confidential information to third parties (shareholders, creditors or debt holders) or the market in general (in case of insider dealing) and supervisory authorities, such as the Bank of Spain or the Spanish Securities Commission.

3.1.8 Duties for listed companies

In addition to the duties mentioned above, the directors of listed companies are required to comply with additional duties.

Article 514 LSC establishes the following rules regarding the directors' voting rights and public request for representation:

> 1. When the directors of a listed company, or any other person on their behalf or in their interest, issue a public request to represent shareholders, the directors obtaining such representation may not exercise the voting rights attached to the shares represented in any of the items on the agenda that may entail a conflict of interest, in particular respecting:
>
> a) Their own appointment or ratification as directors;
>
> b) Their own dismissal, forced separation or removal from their position;
>
> c) The initiation of a liability suit against them by the company; and
>
> d) The approval or ratification, as appropriate, of company transactions with them, companies controlled or represented by them or persons acting on their behalf.
>
> 2. The law also allows the proxy to cover items discussed at the meeting but not on the agenda attached to the notice thereof, in which case the restriction set out in the preceding paragraph shall also apply.
>
> 3. The foregoing is also applicable to the members of supervisory boards of European companies with registered offices in Spain opting for a two-tier system.

This duty to refrain from voting in some decisions is imposed on directors because of their position as representatives of the shareholders and does not relate to the directors' own voting rights. As a result, directors can use their voting power as shareholders to participate in the decisions mentioned above.

[20] Judgment of the Audiencia Provincial of Cruz de Tenerife, number 118/2007, 28 March 2007.

3.2 Who are the duties owed to?

Spain follows the shareholder theory of corporate governance and rejects the stakeholder view. The Code of Good Governance “Olivencia” (1998) supported this argument and the Unified Good Governance Code (2006) declares the following:

> All directors, whatever their provenance or the origin of their appointment, must share the common purpose of defending “the corporate interest”. The Code opts for a contractualist interpretation of this concept which prizes the common interest of the company’s shareholders or, if preferred, the interests of the common shareholder. It sees this option as the most conducive to the effective and targeted exercise of director responsibilities, and also truest to the expectations of the investors to whom the board is finally accountable. For this reason, it urges that the ultimate goal of the company and, therefore, the principle guiding the board in all its actions, should be the maximization of its economic value over time. This seems preferable to other, broader definitions of “the corporate interest”, because it gives the board and the executive bodies under it a clear handle for the adoption of resolutions and their subsequent evaluation.

This statement has been validated by the case law of the Supreme Court in several judgments, in which the Court declared that the interests of the company must be understood as the interests of the shareholders.[21]

However, this does not mean that the directors owe their duties directly to the shareholders. Rather, they are generally owed to the company, with the consequence that the shareholders are not able to bring an action in their own name against the directors for the harm caused to the interests of the company, except when the company itself fails to do so and shareholders representing at least 5% of the share capital instigate the action.

The number of cases involving the breach of directors’ duties to the company is very low. Some reasons may explain this. In part, it is a result of procedural legal problems, particularly for minority shareholders. In addition, tradition and culture plays a role: Majority shareholders are not the natural “users” of this mechanism, and courts are prone to appreciate the harm in the case of the company, but reluctant when the loss affects minority shareholders.

[21] Judgment of the Supreme Court (Sala de lo Civil), number 1086/2002, 18 November 2002.

4 LIABILITY FOR BREACH OF DUTY

4.1 Conditions for liability

The directors' liability for breach of duty is a contractual liability. The role of directors' liability is therefore not different from that corresponding to the overall contractual liability: to satisfy the interests of the counterparty and provide compensation if the breach has caused damage.[22] The general rules on contractual liability apply.

As has traditionally been accepted, the function of liability is to compensate, but also to deter misconduct. It is the legal mechanism to enforce fiduciary duties. In Spain, the duty of care receives more attention than the duties of loyalty, which are underenforced. Moreover, as mentioned, procedural rules on this matter do not promote litigation. Standing is high (5% threshold), which is dramatically high for listed and dispersed companies, as are litigation costs (due to the lack of class actions or contingency fees). Finally, if directors are found liable, they must indemnify the company and not the plaintiff, whereas the plaintiff assumes all costs, expenses (except those which a winning party recovers from the losing party) and effort in the litigation. Therefore, in sum, it is clear that the litigating minority shareholders face little gains and serious inconveniences.

Article 236 LSC establishes the circumstances when liability is incurred:

> 1. *De iure* or *de facto* directors shall be liable towards to the company, its partners or shareholders and creditors for any damage caused by their acts or omissions contrary to law or the by-laws or actions and omissions in breach of the duties inherent in their position.
>
> 2. Under no circumstances shall the adoption, authorisation or ratification of the act in question by the general meeting release them from liability.

In order for a director to be liable, the action or omission must happen during the exercise of the director's functions and powers; there must be an illicit action, consisting in the non-compliance of a duty; fault (culpa) of the director who commits the illicit action; the existence of economic harm (loss to the company); and a causal link between the director's illicit action and the loss suffered by the company. In other words, directors' liability functions as any other civil liability action. The point that needs to be stressed is that in the Spanish system it is far from simple to prove the conditions of the liability – to establish the *quantum* of the harm or the causal link.[23] And this situation is even harder in corporate law cases, where there is no tradition or developed experience by the courts. On top of this, forensic evidence to establish the reduction in the value of a corporation is sophisticated and unfamiliar for the courts (and also for the lawyers). Consequently, its acceptance in, and relevance for, litigation to enforce directors' duties is extremely narrow.

Article 237 LSC declares that directors are joint and severally liable:

> All members of the governing body adopting the detrimental decision or performing the respective act shall answer jointly and severally, unless they prove that, having taken no part

[22] STS 27-XI-08.
[23] Good examples are the following: STS 1-XII-93; STS 16-II-00; STS 6-X-00; STS 8-X-07.

> in its adoption or implementation, they were unaware of its existence or, if aware, took all reasonable measures to prevent the damage or at least voiced their objection thereto.

First, the provision establishes that if the liability of the governing body is proven, this amounts to the liability of each of its individual members. This makes sense in light of the difficulties to prove ex post the internal deliberations of a collegial body. Joint and several liability, however, cannot be considered a mere presumption *iuris tantum* of liability, or a reversal of the burden of proof.[24] The proof of fault or negligence of the directors is borne by the claimant (Article 217 Spanish Civil Procedure Act).

Second, joint and several liability only arises if the wrongful act is a joint action. Therefore, a director is not responsible for the harmful consequences of a wrongful act attributable to the individual conduct of another director.[25] If the breach is the result of a decision of the board, all board members are jointly and severally liable for damages caused to the company, except those who voted against the decision and took steps to prevent it or its harmful consequences. Failure to attend the meeting where the decision was taken is not a cause for exemption because the very absence involves a breach of duty.

In sum, joint and several liability must not extend beyond the limits of the division of labour in the company. Outside directors are not liable for the actions of the executive management unless in cases of fault *in eligendo*, *in vigilando* or *in instruendo*. On the other hand, they are liable to the company if they negligently or unfairly perform the tasks that are assigned to them as non-executive directors.

4.2 Exemptions and limitations

In relation to the exclusion of liability, the adoption, authorisation or ratification of an illicit act by the general meeting does not release the board of directors from liability (art. 236.2 LSC). However, case law and literature state that when the act of the board of directors is a direct result of a resolution of the general meeting, liability can be moderated by means of Article 1103 of the Civil Code.[26]

Waiver of the company's claims against the directors by resolution of the general meeting is permissible (art. 236.2 LSC), albeit it may be opposed by minority shareholders representing at least 5% of the share capital.

4.3 Insurance against liability

Directors and Officers liability insurances appeared in Spain twenty-five years ago, when they were introduced by American companies. They are marketed as D&O insurances or Civil Liability Insurance

[24] Some authors do, for example Eduardo Polo Sánchez*, Los administradores y el consejo de administración de la sociedad anónima: (artículos 123 a 143 de la ley de sociedades anónimas)* (Civitas, 1991).
[25] **Other commentators assert that the articles only constitute a presumption of imputability of an illicit conduct, because guilt is personal. In this view, the plaintiff must prove that the board of directors is guilty of the alleged breach. The defendants, on the other hand, must show** that "having taken no part in [the act's] adoption or implementation, they were unaware of its existence or, if aware, took all reasonable measures to prevent the damage or at least voice their objection thereto." Fernando Marín de la Bárcena, *La acción individual de responsabilidad frente a los administradores de sociedades de capital (art. 135 LSA)* (Marcial Pons) 199.
[26] Article 1103 Civil Code provides that liability arising from negligence is equally enforceable in the performance of all kinds of obligations, but may be moderated by the Courts on a case-by-case basis.

of Administrators and Senior Executives. The law does not make it compulsory to purchase D&O liability insurance and its actual usage is moderate.[27]

D&O insurance is not regulated specifically, but is one kind of civil liability insurance whose regulation can be found in the Insurance Contract Act (Arts. 73-76).

The structure of the contract is very similar to those common in most developed economies. It is important to note, however, that Spanish insurance law allows, as in all cases of civil liability insurance, that the victim of the harm may directly sue the Insurance Company without including the liable party in the lawsuit (*acción directa*: art. 76 Insurance Contract Act).

Side A coverage was fiercely criticised and has mostly been eliminated. If there is not an explicit exclusion, Article 74 of the Insurance Contract Law imposes on the insurer the duty to defend and provide coverage for defense costs. Either the company or the director can be the policy holder. In terms of exclusions, contracts usually state that they do not cover the director's bad faith or illicit profits.

[27] Ángel Rojo and Emilio Miguel Beltrán Sánchez, *La Responsabilidad de los Administradores de las Sociedades Mercantiles* (4th edn, Tirant lo Blanch, 2011).

5 DUTIES IN THE VICINITY OF INSOLVENCY

Article 367 LSC: Joint and several liability of the directors:

> 1. Directors who fail to convene the mandatory general meeting within two months to adopt a decision on dissolution shall be jointly and severally liable for corporate obligations incurred after the legal cause for dissolution took place. Directors who fail to apply for a court ruling to dissolve the company or, as appropriate, to institute insolvency proceedings within two months of the date scheduled for the meeting, if not held, or from the day of the meeting, if the dissolution proposal is defeated, shall be equally liable.
>
> 2. In such cases, corporate obligations constituting the object of claims shall be regarded to be subsequent to the legal cause for dissolving the company unless the directors can substantiate that they are dated prior thereto.

This article applies when the dissolution is the consequence of a loss of assets. The norm is aimed at preventing wrongful trading. Nevertheless, it is important to note that this is an extremely severe penalty for several reasons. First, its application does not depend on the capacity of corporate creditors to collect their claims over the company's assets or on the fact that the failure of managers to dissolve has placed the company into insolvency. Second, the late compliance with the duties does not exclude liability. In this sense, the provision operates as a case of strict liability.

Directors are liable to company creditors, so neither the company nor its shareholders can bring a lawsuit. The provision does not establish liability for damages (if it were so, the penalty would not be to answer for the company's debts, but to compensate the company for the damage suffered as a consequence of the failure to dissolve the company in a timely manner).

In this sense, the provision constitutes a pre-insolvency standard, but also an alternative to insolvency. It is useless to open insolvency proceedings if there are no assets; to hold the directors liable under Article 367 LSC is a much simpler way to obtain payment for outstanding debts. Previously, the judicial declaration of insolvency did not prevent creditors from suing managers on the basis of Article 367 LSC if they breached the duties imposed upon them by this provision. To prevent this practice, the insolvency Act has recently been amended: Art. 50.2 states that the judge will not admit these claims if the company has filed for bankruptcy.

It is also worth mentioning that Article 367 LSC has been more effective than other fiduciary duties imposed upon directors. Case law shows that this provision is in fact – and by a large margin – the major liability risk faced by directors in Spain.[28]

[28] Case law is rich regarding this matter, STS 14-V-07, 10-VII-08, 19-IX-07, 20-II-07, 27-VI-08. 26-V-06 (assessing the quasi-strict liability character of the provision); STS 28- IV-06, 2-VI-08 y 11-VII-08 (it is not required to prove economic loss, fault or causality).

5.1 The meaning of ‘vicinity of insolvency’

According to Article 5 of the *Ley Concursal* (Insolvency Act) (LC), the debtor must request the declaration of insolvency within two months following the date when the debtor knew or should have known of the insolvency. Insolvency is defined as the situation when the debtor cannot regularly fulfill his obligations (Article 2.2 LC).

Article 6 states that the debtor can apply for an insolvency order from the judge not only when the company has become insolvent, but also when insolvency is imminent. The filing must be accompanied by the following documents: a special power to apply for the insolvency order, a legal and financial report, an inventory of assets, a list of creditors, a list of employees, and the annual accounts for the last three years.

Pursuant to art. 22 LC, the insolvency procedure can be voluntary or necessary. It is the former where the debtor is the person who requests the declaration of insolvency. If this is not the case, it will be a necessary proceeding. This distinction is important in order to analyse the effects of the declaration of insolvency on the debtor.

Article 40 LC establishes that, as a general rule, in the case of voluntary proceedings, the debtor is allowed to continue to exercise the powers of administration and disposition of the company assets; however, he is under the supervision of the administrators, whose authorisation or consent is required.

In case of a necessary proceeding, as a general rule, the court will suspend the debtor’s power of administration and dispose of the company’s assets. These powers are henceforth conferred on the insolvency administrators.

Article 42 LC determines a duty of collaboration and disclosure of information. The debtor must appear in the commercial court during the administration of the insolvency proceeding as many times as required. The debtor must cooperate and disclose information. This duty must be carried out by the current directors of the company and the former directors who served on the board within the last two years from the declaration of insolvency.

In addition, the debtor must make available to the administrators all necessary documents, books and registry entries related to the assets of the company.

5.2 Newly arising duties

As far as the effects of the declaration of insolvency for purposes of the directors’ liability are concerned, Article 48 quáter LC states that the administrator of the insolvency proceedings is the only body empowered to bring legal actions on behalf of the company against its directors.

The insolvency procedure can be classified as ‘not caused by the culpable acts of the directors’ (“*fortuito*”) or as ‘guilty’ (“*culpable*”), see art. 163 LC. It is guilty if intentional or grossly negligently acts of *de iure* or *de facto* directors caused or aggravated the state of insolvency. As a consequence, the court may order the guilty directors to cover the deficit in the company's assets completely or partially. This liability also applies to individuals who are no longer directors, but held that position during the last two years before opening of the insolvency proceedings.[29]

Pursuant to Article 172 LC, the ruling shall declare the insolvency as fortuitous or guilty. The ruling classifying the insolvency as guilty shall also specify the persons affected by the classification (among others, *de iure* or *de facto* directors in the two years immediately prior to the declaration of insolvency) and the prohibition of persons affected by the classification from administering third party goods for a period ranging from two to fifteen years, as well as from representing or managing any person during that same period, in all cases depending on the severity of the facts and the scope of the damage.

Act 38/2011 (October 10, 2011), which amends LC, has introduced some modifications. One of them is the new Article 172bis LC, which deals with liability on insolvency and tries to harmonise the insolvency regime with that regarding the liability for damages to the company (art. 48 quáter LC).[30] It declares that when the assessment section of the proceeding has been formed or reopened as a consequence of opening the winding-up phase, or the insolvency procedure has already been assessed as guilty and the reorganisation agreement has been infringed, the ruling will condemn the *de iure* or *de facto* directors or general agents of the company to pay the full or a partial amount of the company's debts to the insolvency creditors that cannot satisfy their claims from the company's assets. If more than one person is liable, the ruling must specify the amount that each individual must pay according to his participation. Notice that high liability reduces the incentives of the debtor to file for bankruptcy (the Spanish rate is much lower compared with other European countries).

The insolvency administrator is the only body empowered to ask for the execution of the judgment. In case this is not carried out within one month, the creditors who requested the execution of the judgment are empowered to enforce it (Article 172bis.2 LC).

[29] The Insolvency Act specifies the conduct for which the presumption of culpability does not admit evidence to the contrary and the conduct for which it does admit evidence to the contrary.
164.2. LC: In any case, the insolvency shall be classified as guilty when any of the following cases arise:

1) When the debtor legally obliged to keep accounts substantially breaches that obligation, keeps double accounts, or has committed a material irregularity impeding adequate comprehension of the subjacent economic or financial situation;
2) When the debtor has committed a severe misrepresentation in any of the documents attached to the petition to declare the insolvency proceedings open or in those submitted during such proceedings, or when he has attached or submitted false documents;
3) When opening the winding-up has been resolved by Court acting on its own motion due to breach of the composition for causes due to the insolvent debtor;
4) When the debtor has embezzled all or part of his assets to the detriment of his creditors, or has performed any act that delays, hinders, or prevents the effectiveness of a seizure of any kind of enforcement commenced or whose commencement is foreseeable;
5) When, during the two years prior to the date of insolvency proceedings being declared open, properties, goods or rights have fraudulently been detracted from the debtor's estate;
6) When before the date the insolvency proceedings are declared open, any legal act aimed at simulating a fictitious state of assets has been performed.

Article 165. Presumptions of malicious intent or gross negligence.
The existence of malicious intent or gross negligence shall be presumed, in the absence of evidence to the contrary, when the debtor, or if appropriate, his legal representatives, directors, or liquidators:

1) Have breached the duty to petition for a declaration opening the insolvency proceedings;
2) Have breached the duty to collaborate with the insolvency Court and the insolvency administrators, have not provided them the necessary or convenient information for the interests of the insolvency proceedings, or have not attended the creditors' meeting, personally or by means of a proxy;
3) If the debtor who is legally bound to keep the accounts has not formulated the annual accounts, has not submitted them to audit, when bound to do so, or, once approved, has not deposited them at the Business Register in any of the three business years preceding insolvency being declared.

[30] In the preamble to Act 38/2011, VIII, the legislator clearly stated that it intended to solve the problems of application to the courts.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue

Spanish law provides for two main enforcement mechanisms: the corporate action and the individual action for liability.

6.1.1 The company as plaintiff

Claims of the company against the directors are enforced by the company following a resolution of the general meeting. In order to protect minority shareholders against interested decisions by the majority, the law makes two instruments available: on the one hand, the minority shareholders may veto the general meeting resolution to reach a settlement or waive the claim (art. 238.2 LSC); on the other hand, they may bring a derivative suit to defend the corporate interest when the general meeting decides not to claim liability, a resolution was adopted to file the claim, but it is not executed, or there is no decision by the general meeting (art. 239 LSC). Besides, when there is no action for liability by the company or shareholders, creditors can bring such action, but only when the company has insufficient assets to repay its debts (art. 240 LSC).

It is necessary to stress that the law only grants the company standing to sue the directors by virtue of a decision of the general meeting (art. 238.1 LSC). As in most continental jurisdictions, the instigation of legal proceedings falls within the remit of the general meeting. This is justified because the shareholders are the individuals prejudiced if the assets of the company are negatively affected. But the argument is generally more dogmatic and holds that the company, as claimant, has standing. According to the rules of the legal entity, directors are the representatives of the company. Because they cannot be the entrusted with the power to sue themselves, the solution achieved is that the decision to take legal action should be adopted by the general meeting.

Granting the general meeting the power to bring a lawsuit on behalf of the company requires that the shareholders must have enough information to take the decision.[31] This is ensured by art. 197 LSC. Nevertheless, the allocation of standing to the majority of shareholders leads to a deficit in enforcement because directors can often rely on the support of the controlling shareholders. For this reason, minority shareholders and creditors are granted a derivative capacity to sue. However, they do not replace the company. They can bring actions against the directors, but they cannot settle or waive the claims with effects *vis-à-vis* the company or third parties. It is understood that they do not

[31] Article 197. Right to information in public limited companies
1. Shareholders may ask the directors to provide any information or clarification that they deem necessary about the items on the agenda, or pose any questions they deem appropriate, in writing up until the seventh day before the date on which the meeting is scheduled to be held.
The directors shall be bound to furnish the information in writing by the date of the general meeting.
2. During the general meeting, the company's shareholders may verbally request any information or explanations that they deem necessary with respect to the items on the Agenda, and whenever their queries cannot be immediately answered, the directors shall be obliged to provide the information in writing no more than seven days after the general meeting.
3. The directors shall be bound to furnish the information requested pursuant to the provisions of the two preceding paragraphs except in cases where, in the chairperson's opinion, disclosing the information requested may be detrimental to the company's interests.
4. Information may not be withheld when requested by shareholders representing at least one-fourth of the share capital.

only defend their own interest, but also the interest of the company. Consequently, what they obtain from the legal action goes to the company. They can obtain reimbursement for expenses of such action if the claim is successful.[32]

Typically, the resolution to bring a corporate action is reached in a meeting where the agenda lists this item. However, if the directors do not cooperate to convene the meeting, art. 238.1 LSC states that the decision "may be adopted at the behest of any shareholder even where not included in the agenda."

As far as the majority required to take the decision is concerned, the by-laws cannot require a qualified majority for the adoption of such decisions (art. 238.1 LSC). A simple majority is always sufficient.[33]

According to Article 238.3 LSC, the decision to bring an action or reach a settlement shall entail the dismissal of the directors concerned. The reason is that the relationship of confidence between the directors and the shareholders is broken if it comes to litigation. However, the by-laws can change this provision. *A contrario*, if the action is promoted by the minority, dismissal is not requested, even if the directors are found liable.

The general meeting can reach a settlement or waive the legal action at any time (art. 238.2 LSC). Settlement or waiver implies that the general meeting is no longer empowered to bring the same corporate action. This serious consequence is the reason why Article 238.4 LSC states that the approval of the financial statements shall not preclude action for liability nor constitute a waiver of the action agreed or brought. However, shareholders representing five per cent of the capital can raise an objection. The aim pursued by this provision is to avoid the board and majority shareholders entering into opportunistic transactions, which may damage minority shareholders.

As we have seen above, shareholders representing at least five per cent of the capital may request the general meeting to decide whether to bring an action for liability. Since the minority shareholders act in the interest and on behalf of the company, the law does not grant standing to each shareholder individually. Besides, they may also jointly bring an action for liability to defend the corporate interest when the directors fail to convene the general meeting requested, when the company fails to bring such action within one month of the date of adoption of the respective resolution, or when the meeting decides not to claim liability (Art. 239 LSC).

The first case refers to the situation where the directors fail to convene the general meeting requested by the minority shareholders. The general meeting must be convened within two months following the date on which the directors receive the notarised request from the shareholders (art. 168 LSC). From this moment, the minority shareholders may sue the directors or ask the commercial court of the place where the company's registered office is located to convene the meeting (art. 169 LSC).

On the other hand, the company's creditors may institute a corporate action for liability against the directors when no action is brought by the company, its partners or shareholders, and if the company has insufficient assets to repay its debts (Art. 140 LSC). The aim of this action is not the enforcement

[32] Guillermo Guerra Martín, *La responsabilidad de los administradores de sociedades de capital* (La Ley, 2011) 130.
[33] Article 201.1: in public limited companies, corporate decisions shall be adopted by a majority of the votes of the shareholders present in person or by proxy.

of a claim by the creditors to receive payment, but to preserve the assets of the company. Commentators point out that the creditors' capacity to bring a corporate action is subsidiary to that of the minority shareholders.

Finally, it should be noted that the action against the directors of companies or firms shall be time-barred after four years from the time when the partner or director ceases to hold office for any reason (art. 949 Commercial Code).

6.1.2 The shareholders as plaintiffs

Article 241 LSC establishes that shareholders or third parties can bring a claim for damages against the directors in their own name if the directors have acted in a way that directly harms their interests. As far as the scope of the provision is concerned, the article refers to 'directors' actions', which is interpreted mainly as actions carried out while the individual acts as a director.

In order to delineate the scope of the corporate action and the individual action for liability, scholars and the courts focus on the assets or interests that have been harmed. Thus, damage to the company's assets must be claimed through the corporate action, whereas the individual action can be used when the directors' action is not directly detrimental to the company's assets (see art. 241 LSC). Consequently, we can infer that the individual action cannot be used to claim an indirect loss.[34]

Outside the scope of Article 241 LSC a majority strand of the literature states that general tort law is applicable (Article 1902 of the Civil Code).[35] However, a minority view argues that the so-called individual action for liability is different. They submit that this is not a special lawsuit, but a referral.[36] Article 236 LSC stipulates that directors are liable vis-à-vis the company, but they may also be sued for damages for actions that took place while acting as directors according to general rules (art. 1902 Civil Code) or other provision outside corporate law (art. 20 Unfair Competition Act).

A controversial issue is the nature of this liability. Some scholars (the majority) have qualified it as tortious in nature, whereas others argue that it should be qualified as either contractual or extra-contractual, depending on the nature of the relationship between the director and the third party (shareholder or not) who claims liability. The Supreme Court has not helped to clarify this question.

Another important issue arises with regard to the determination of the applicable legal regime. Some argue that Article 1902 of the Civil Code applies outside the scope of art. 241 LSC to fill the gaps in the legal regime. Others (the majority) claim that Articles 236 and 237 LSC apply to fill the loopholes.

Finally, the Supreme Court struggled with the issue of the period of limitation of the shareholder action pursuant to art. 241 LSC for some time. In the end it opted for applying the four year term laid down in Article 949 of the Commercial Code, which starts from the time of leaving the office as director.

[34] Gaudencio Esteban Velasco, "*Algunas reflexiones sobre la responsabilidad de los administradores frente a los socios y terceros: acción individual y acción por no promoción o remoción de la disolución"* 1995 RdS, 5, 47-78.
[35] Article 1902 Civil Code provides: "The person who, as a result of an action or omission, causes damage to another by his fault or negligence shall be obliged to repair the damaged caused."
[36] Jesus Alfaro Águila-Real. "La llamada acción individual de responsabilidad "externa" de los administradores sociales. Segunda edición. Jesús Alfaro Aguila-Real Indret: Revista para el Análisis del Derecho" *InDret* 1 (2007).

7 CONFLICT OF LAWS

7.1 Company law

The law applicable to a company (lex societatis) is derived from Article 9.11.1 of the Civil Code, which states the following:

> The personal law corresponding to legal entities shall be determined by their nationality, and shall apply in all matters relating to their capacity, incorporation, representation, operation, transformation, dissolution and termination.

The legislator tries to regulate all important aspects of the company under the same law (incorporation, operation, relationships between shareholders, with the directors, the capacity of the company, and liability). As a result, it does not matter where the company is operating because the internal relations of the company, its capacity and liability to third parties are regulated by the same law.

The reason for this rule is the protection of the company and the shareholders' interests. Likewise, it promotes the internationalisation of companies. However, the following issues fall outside the scope of the lex societatis:[37]

- The so-called constitutional law of the company, which provides for employee participation in the company. This is regulated by the domestic labour law.
- The registration of branches of foreign companies in Spain is governed by Spanish law.

Even though Article 9.11.1 of the Civil Code does not include directors' liability explicitly, scholars argue that the lex societatis encompasses question of liability, because the article provides for the general principle of unity of company law. The residence or nationality of the creditors is irrelevant where the lex societatis applies. This is also confirmed by case law.[38] An exception is acknowledged for the case of corporations incorporated in a third country where the company's activities and other factors create the impression that it is a Spanish company. To avoid this type of fraud, the principle of Article 9.2 LSC[39] may apply, with the consequence that the directors' liability would be governed by Spanish law.

Articles 8 and 9 LSC are relevant to ascertain the applicable law. Article 8 states that "[a]ll corporate enterprises with registered offices on Spanish soil, irrespective of the place of formation, shall be Spanish and subject to this Act." Article 9 states:

> 1. Corporate enterprises shall establish their registered office at the place on Spanish soil where their actual administrative and management activities, or their main business establishment or operation, are located.
>
> 2. Corporate enterprises whose main business establishment or operation is on Spanish soil shall have a registered office in Spain.

[37] Guillermo Guerra Martín, *La responsabilidad de los administradores de sociedades de capital* (La Ley, 2011) 905.
[38] Judgment of the Audiencia Provincial of León, number 81/2008, 7 May 2008.
[39] See below in the main text.

As we can see, the general rule is that the company's place of incorporation is the connecting factor in identifying which law should apply. The exception is the second provision, which refers to the case of pseudo foreign corporations.

The case law is old and somehow confusing, but it supports the incorporation theory and declares that a company is Spanish if it is incorporated under Spanish law and has its registered office in Spain. Thus, it does not matter where the head office or the main operating center is located.

In the event of discrepancies between the registered office entered in the Mercantile Registry and the actual headquarters, third parties may consider either to be the valid address (Article 10 LSC). If a company is incorporated under the Spanish law but does not have its registered office in Spain, the provision for companies in irregular situations applies (Article 39 LSC), which states:

> Once the intention to refrain from registering a company has been confirmed and, in any event, when no application for registration is filed within one year of the date of formalisation of the deed, it shall be governed by the rules for general partnerships or, as appropriate, non-mercantile organisations, if the company in the process of formation has undertaken or continued operations.

These rules change in cases concerning corporations from the European Union. According to Article 54 TFEU and the case law of the European Court of Justice, a company incorporated and registered in a Member State can have its main business establishment or operation in Spain, but it does not have to be incorporated nor have its registered office in Spain.

7.2 Tort Law

Regulation 864/2007 (Rome II) provides for the private international law regarding non-contractual obligations. Pursuant to Article 4(1), the law applicable to a non-contractual obligation arising out of a tort shall be the law of the country in which the damage occurs irrespective of the country in which the event giving rise to the damage occurred and irrespective of the country or countries in which the indirect consequences of that event occur.

However, where it is clear from the circumstances of the case that the tort is manifestly more closely connected with another country, the law of that other country shall apply (Article 4(2)).

7.3 Insolvency law

The Insolvency Act provides for directors' duties and liability in the case of insolvency (as we have seen above), whereas the general duties are regulated by the LSC. Article 11 LC defines the material scope of the insolvency court's international jurisdiction in the following way:

> In the international field, the jurisdiction of the insolvency Court only includes hearing and deciding actions that have their legal grounds in the insolvency legislation and that are immediately related to the insolvency proceedings.

The jurisdiction of Spanish courts in insolvency is determined by Article 10 LC, which implements art. 3 of the EU Insolvency Regulation.[40] Directors' liability pursuant to Article 172.3 LC Act is considered to be part of Spanish substantive insolvency law.[41] Accordingly, it is applicable if the Spanish insolvency courts have international jurisdiction.

As the preamble of the LC states, the Act "contains rules of Conflict of Laws on this matter, which adhere, with the appropriate adaptations, to the model of Regulation (EC) no. 1346/2000 on insolvency proceedings. Thus, the application of both texts is facilitated within the intra-community area and the same regulatory model is applied to the regulation of other legal relations that are beyond that territorial scope. In that sense, the new provisions are also inspired by the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency, recommended by the Assembly General of the United Nations Organization in its Resolution 52/158, dated 15th December 1997." In order to clarify this issue further, Article 199 LC declares that it applies without prejudice to the provisions contained in the Insolvency Regulation 1346/2000.

[40] Article 10. *International and territorial competence.*
1. The competence to declare and deal with the insolvency lies with the Mercantile Court of Law in whose territory the debtor has the centre of his main interests. If the debtor has his domicile in Spain and such domicile does not coincide with the centre of his main interests, the Mercantile Court of Law in whose territory the domicile is situated shall also be competent, at the petitioner's creditor choice.
The centre of main interests shall be understood as the place where the debtor usually performs the management of those interests, in a form recognisable by third parties. In the case of a legal person, the centre of its main interests is presumed to be at the place where the registered office is located. Changes of registered office performed in the six months preceding the petition for insolvency shall be ineffective for these purposes.
The effects of this insolvency, which shall be considered the "main insolvency proceedings" from an international perspective, shall have a universal scope, including all the assets of the debtor, whether they are located within or without Spain. In the event of insolvency proceedings being commenced upon assets located in a foreign state, the rules of co-ordination foreseen in Chapter III of Title IX of this Act shall be taken into account.
2. If petitions to declare insolvency have been submitted before two or more competent courts, preference shall be granted to the one where the first petition was lodged.
3. If the centre of main interests is not in Spanish territory, but the debtor has an establishment there, the Mercantile Court of Law in whose territory it is located shall be competent and, if there are several, where any of them is situated, at the petitioner's choice.
An establishment is understood as any place of operations at which the debtor carries out a non-transitory economic activity with human means and goods.
The effects of this insolvency, which in the international scope shall be considered a "secondary insolvency"; shall be limited to the assets of the debtor; whether or not they are vested for his activity, that are located in Spain. In the event of the State where the debtor has the centre of main interests opening insolvency proceedings, the co-ordination rules foreseen in Chapter IV of Title IX of this Act shall apply.
4. In cases of petition for joint declaration opening the insolvency proceedings of several debtors, the competent Court of Law to declare them shall be the one of the place where the debtor with the largest liability has his centre of main interests, and if a group of companies, that of the parent company.
The same rule shall apply to determine the competent Court of Law to process accumulated
5. The Court shall examine its competence on its own motion and shall determine whether it is based on Paragraph 1 or Paragraph 3 of this Article.
[41] Juan Sánchez-Calero and Vicente Guilarte Gutiérrez, *Comentarios a la Legislación Concursal* (Lex Nova, 2004) 341.

DIRECTORS' DUTIES AND LIABILITY IN SWEDEN

Initial author: Helene Eriksson

Contents

1 INTRODUCTION

1.1 Domestic corporate landscape

Swedish legislation differentiates between two types of limited liability companies:[1] public companies (*publika aktiebolag*) and private companies (*privata aktiebolag*). However, most rules apply to both types of companies. Differences between the two types of companies mainly exist in relation to the raising of capital by the two company types; a public, but not a private, company may turn to the public to raise equity or loan capital.[2] Most importantly, only public company's shares may be listed on a regulated market or an MTF.[3]

There are approximately 400.000 private companies and 1.500 public companies in Sweden. Approximately 400 of the public companies are listed on a stock market.

Ownership structure on the Swedish stock market is characterised by a relatively high degree of concentration; listed companies are often controlled by a single shareholder or a small group of shareholders. Such major shareholders often play an active role in the governance of companies; frequently, major shareholders also act as board members.[4]

As the Swedish Corporate Governance Code emphasises, the engagement and influence of major shareholders is generally seen as having a positive effect on Swedish corporate governance. As concentrated ownership also creates risks, particularly for minority shareholders, the Companies Act *"contains a number of provisions, which offer protection to minority shareholders, such as requiring qualified majorities for a range of decisions at shareholders' meetings."*[5]

1.2 Relevant Laws and Regulations

In Sweden companies with limited liability are regulated mainly by statute. The major law is the Companies Act (*Aktiebolagslagen* (2005:551), hereafter "Companies Act") which entered into force on 1 January 2006. The Companies Act contains detailed rules regarding the shareholders' meeting, board of directors and the managing director. The Companies Act also regulates liabilities in case its rules are breached and the sanctions to be applied in such a case.

The Companies Act is complemented by some other laws such as the Annual Accounts Act (*årsredovisningslagen* (1995:1554)) and the Private Sector Employees Board Representation Act (*lagen* (1987:1245) *om styrelserepresentation för de privatanställda*). Financial institutions and insurance companies that are incorporated as limited liability companies used to have separate rules but now have to follow the regulations in the Companies Act. Some special regulations, such as the Act Regulating Banks and Financial Institutions (*lagen* (2004:297) *om bank- och finansieringsrörelse*), supplement the Companies Act with respect to certain industries.

[1] Rolf Skog, Rodhes Aktiebolagsrätt (23rd edn, Norstedts Juridik, 2011), chapter 1.C.
[2] Companies Act, Chapter 1, Section 7.
[3] Rolf Skog, Rodhes Aktiebolagsrätt (23rd edn, Norstedts Juridik, 2011), chapter 1.C. Currently, there are two regulated markets in Sweden, NASDAQ OMX Stockholm and NGM Equity.
[4] See Swedish Corporate Governance Code, Chapter II.2 - The Swedish Corporate Governance model.
[5] Ibid.

The most central rules for the Swedish securities market are defined in the Financial Markets Act (*lagen* (2007:528) *om värdepappersmarknaden*) and the Financial Trading Act (*lagen* (1991:980) *om handel med finansiella instrument*).

The statute is complemented by rules such as the Swedish Corporate Governance Code (Svensk kod för bolagsstyrning, (hereafter the "Code"). The Code was drafted and revised by The Swedish Corporate Governance Board. The Code is an integral part of the self-regulation system on the Swedish securities market.[6] The Code initially came into force on 1 July 2005 and has been revised in 2008 and 2010. It is a set of guidelines that follow the *comply or explain*-principle.

The target group for the Code are companies whose shares are traded on a regulated market in Sweden and these companies are in the respective market obliged to follow the Code. The Code also contains some guidelines which simply reiterate binding legal rules and are thus in effect mandatory. A company who wishes not to comply with a Code rule must therefore first check whether there is an equivalent mandatory regulation.[7] Companies that follow the Code must give an account of how they have applied the Code in an annual corporate governance report. This report should include any deviations from the Code, alternative solutions and the reasons for these deviations.

1.3 Company organisation

Board structures are often classified following the "monistic" / "dualistic" divide. Under the typical "dualistic" model, a company has two distinct boards, one with purely supervisory functions and a management board responsible for the day-to-day management. Under the "monistic" model, on the other hand, the two functions are exercised by a unified board, such as typically the case under UK law. The Swedish model does not clearly fit into either of the two categories, but it is closer to the "monistic" model, since the board has functions that go beyond purely supervisory tasks.[8]

The Chief Executive Officer and the managing director of a Swedish company are often not, however, members of the board of directors, which is an important difference when compared to, for instance, UK law.

A Swedish limited liability company has a hierarchical structure, which is an essential starting point when determining the company's management liability.[9] Chapter 8 in the Companies Act regulates how a company should be governed. The shareholders' meeting constitutes the superior decision-making body to which the board of directors and the managing director (mandatory in public companies) are subordinated. The board is liable for the company's organisation and the management of the company's business while the managing director, if applicable, is liable for the day-to-day management of the company in accordance with the board of directors' guidance.[10] The board and the managing director must follow specific directives given by the shareholders' meeting unless they are contrary to the Companies Act or the company's articles of association.[11] The boards monitoring function is emphasised by the rule that the chair of the board of directors of a public company may not be the company's managing director simultaneously.[12]

[6] The Swedish Corporate Governance Board, http://www.corporategovernanceboard.se/, accessed on 8 February 2012.
[7] Jenny Keisu, 'Svensk kod för bolagsstyrning – bättre att förklara än att följa?' (2008-09) 20 Juridisk Tidskrift 720.
[8] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 31.
[9] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008) p. 30
[10] Companies Act, Chapter 8, Section 4 and 29.
[11] Companies Act, Chapter 8, Section 41 (2).
[12] Companies Act, Chapter 8, Section 49.

2 The concept of 'company director' in Sweden

2.1 *De jure* directors

2.1.1 Requirements to become a *de iure* director

The board of directors and the managing director form the management of a company and are subject to the Companies Act's provisions about management (Chapter 8). Although an executive management team, assisting the managing director in the performance of his or her duties, is a common body in large companies, it is not recognised in the Companies Act and its members are not part of management from the Companies Act's point of view. For the purposes of this report, unless specifically stated otherwise, "a director" refers to a member of the board of directors.

According to the Companies Act, the directors are appointed by the shareholders at the shareholders' meeting. The articles of association may, however, state that one or several directors are to be appointed in a different manner.[13] In a public limited liability company at least half of the directors must be appointed by the shareholders' meeting.[14] There is no statutory right for minority shareholders to elect a director. The articles of association may, nevertheless, include provisions giving minority shareholders a right to be represented on the board.[15] The managing director is appointed by the board of directors.[16]

The minimum number of board members is stated in the Companies Act.[17] The board in a public company must consist of a minimum of three directors whereas a private company needs one or two directors provided that there is at least one deputy director.[18] The number of directors has to be indicated in the articles of association. It is possible to state a minimum and a maximum number instead of a fixed number.[19] When the board consists of more than one director, one of the directors has to be designated as chair. The chair is chosen by the board of directors unless otherwise stated in the articles of association or decided by the shareholders.[20]

According to the Companies Act, the directors are appointed for a term until the close of the first annual general meeting held after the year in which the board member was appointed, unless the articles of association state otherwise. The appointment shall, however, terminate no later than the close of the annual general meeting which is held in the fourth financial year after the financial year in which the board member was appointed.[21] A managing director is appointed for the time being.[22] When a director or managing director has been appointed this has to be registered with *Bolagsverket*

[13] Companies Act, Chapter 8, Section 8.
[14] Companies Act, Chapter 8, Section 47.
[15] Rolf Skog, Rodhes Aktiebolagsrätt (23rd edn, Norstedts Juridik, 2011), chapter 8.
[16] Companies Act, Chapter 8, Section 27 and 50.
[17] Companies Act, Chapter 3, Section 1.
[18] Companies Act, Chapter 8, Section 46.
[19] Companies Act, Chapter 3, Section 1.
[20] Companies Act, Chapter 8, Section 17.
[21] Companies Act, Chapter 8, Section 13.

(the Swedish Companies Registration Office) for the appointment to become effective.[23] The powers as well as the duties and liabilities that come with the nomination become effective at the earliest when notice of the appointment has arrived to *Bolagsverket*. The decision regarding the appointment may state that the effects of the appointment shall begin at a later date.[24]

A director and a managing director may be dismissed at any time by the same corporate body that appointed him or her. A director may also resign from the position at any time. This is done by giving notice to the remaining board. The effect of the resignation takes place when notice of the resignation is given to *Bolagsverket*.[25]

The managing director may be a board member but cannot be the chairman of the board in public companies.[26] The Code provides that no more than one of the directors elected by the shareholders' meeting may be on the executive management team of the company or one of its subsidiaries.[27] Normally, the managing director takes this place. However, it is also common that no member of the executive management team is a member of the board. Hence boards of Swedish listed companies are composed entirely or predominantly of non-executive directors.[28]

2.1.2 Who can be de iure director?

According to the Companies Act, only natural persons with unrestricted legal capacity can become board members in a company. Therefore, companies and other legal persons are prohibited from becoming directors in Swedish companies. Furthermore, the Companies Act stipulates the following negative prerequisites: directors may not be underage, bankrupt, under custodianship or banned from engaging in commercial activities.[29] Essentially the same requirements apply to the managing director.[30] The law also prohibits the shareholders from appointing a person as director or managing director who has no genuine intention to participate in the business of the company unless there are reasonable grounds (*godtagbara skäl*).[31]

Directors are not required to possess special knowledge within the field of the company's business. It is considered that such requirement would lead to a unilateral board composition. The director is instead required to have a general ability to get acquainted with the company's business and personal skills to complete the task.[32]

The Companies Act provides that at least half of the board and the managing director have to be residents in the EEA. *Bolagsverket* may grant special permissions for more foreign board members or a managing director domiciled outside the EEA.[33]

[22] Companies Act, Chapter 8, Section 33.
[23] Companies Act, Chapter 8, Section 43 (1).
[24] Companies Act, Chapter 8, Section 13, Rolf Skog, Rodhes Aktiebolagsrätt (23rd edn, Norstedts Juridik, 2011), chapter 8.C.a.
[25] Companies Act, Chapter 8, Section 13 and 14, Rolf Skog, Rodhes Aktiebolagsrätt (23rd edn, Norstedts Juridik, 2011), chapter 8.C.a.
[26] Companies Act, Chapter 8, Section 49.
[27] Code, Chapter III.4.4.
[28] Code, Chapter II.3.
[29] Companies Act, Chapter 8, Section 11.
[30] Companies Act, Chapter 8, Section 31.
[31] Companies Act, Chapter 8, Section 12 and 32.
[32] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 74.
[33] Companies Act, Chapter 8, Section 9 and 30, Rolf Skog, Rodhes Aktiebolagsrätt (23rd edn, Norstedts Juridik, 2011), chapter 8.C.a.

The Code states that a majority of the members of the board are to be independent of the company and its management. The Code describes in detail what is considered an independent director.[34] The Code also indicates that at least two board members must be independent of the company's major shareholders, which means that it is possible for major shareholders of Swedish companies to appoint a majority of board members.[35] This is in line with the positive view of active and responsible ownership expressed in the preparatory works to the Companies Act.[36]

2.2 *De facto* and shadow directors

The Swedish Companies Act does not make a categorical difference between *de facto* and *de iure* directors. There is no statutory law that stipulates liability for *de facto* and shadow directors in Sweden. However, concerns around *de facto* and shadow directors have been given attention in preparatory materials, explanatory memoranda, case law and in legal literature. The preparatory materials, for instance, refer to these concepts as a possible ground for liability, citing that not only formal directors may be held liable.[37] Similarly, case law confirms that a person not formally appointed, but carrying out tasks and making decisions as if he or she was a director, could be liable on the same grounds as a formal director. [38]

Despite mentioning that *de facto* directors and shadow directors may be held liable, neither preparatory works nor case law stipulates conditions for liability under Swedish law. Moreover, no distinction is made between the two concepts. However, in legal literature inspired by foreign law, the conditions for *de facto* director and shadow director have been categorised. A *de facto* director is i) a person that has acted in the same way as if he or she was a formal director, and ii) the company either knew or consented to this. Furthermore, the conditions for shadow director is said to be i) a person that has given instructions to the company, typically to the board or the managing director, and that ii) the company followed these instructions in a way which lead to a regular practice.[39]

2.3 Employee participation

The right for employees to be represented on the board of directors are regulated by the Private Sector Employees Board Representation Act (*lagen* (1987:1245) *om styrelserepresentation för de privatanställda*). In the preliminary part of the law it is stated that its purpose is to give employees an insight in and an influence on the company's operations. The law is applicable on companies that have had an average of at least twenty five employees in Sweden during the previous financial year.

The employees may appoint two board members and one deputy board member for each appointed board member. If the company conducts business in different sectors and the average employee amount during the previous financial year was above 1,000 employees, three board members and three deputy board members may be appointed.[40] The shareholders' meeting may decide that the law shall apply even if the employee number does not reach twenty five. The decision to appoint employee representatives on the board is taken by a regional branch of a trade-union with a collective

[34] Code, Chapter III.4.4.
[35] Code, Chapter III.4.5.
[36] Code, Chapter II.3.
[37] SOU 1998:47, prop. 2000/01:150 p. 70 and 76. Svernlöv, p. 45.
[38] NJA 1997 p. 418, *obiter dicta* on page 452.
[39] Svernlöv, p. 48.
[40] Law on Employee's Representation on the Board of Directors, Section 4.

employment agreement (kollektivavtal) with the company. The regional branch of the trade-union may demand to be represented on the board but it does not have to do this.[41]

The law particularly states that the amount of employee board members may not exceed the amount of other board members.[42]It is possible to make exceptions to the general employee participation framework where a director representing the employees would create a “serious inconvenience” (*väsentlig olägenhet*) for the company, for example if the directors, according to the articles of association, are to be appointed in such a way that it creates a particular balance between certain shareholders. When such an exception is granted, the company has to provide an alternative solution to give employees an insight and an influence over the company’s operations.

A director who represents the employees may not participate when the board deals with questions regarding collective employment agreement or other questions where the trade-union may have interests conflicting with the company’s interests.[43] Under Swedish law, employee representatives have the same liability when acting as board members as board members appointed by the shareholders or otherwise.[44]

[41] Rolf Skog, Rodhes Aktiebolagsrätt (23rd edn, Norstedts Juridik, 2011), chapter 10.A.
[42] Law on employee’s representation on the board of directors, Section 4.(2).
[43] Rolf Skog, Rodhes Aktiebolagsrätt (23rd edn, Norstedts Juridik, 2011), chapter 10.A.
[44] Prop. 1987/88:10 p. 68.

3 THE SCOPE OF DIRECTORS' DUTIES UNDER SWEDISH LAW

3.1 Introduction

As described in section 1.3 above, a Swedish company has a hierarchical structure. The basic allocation of tasks between the board of directors and the managing director follows from the Companies Act.[45] The primary task of the board of directors is to organise the company's operations and management of the company's affairs, whereas the managing director is liable for the day-to-day activities of the company.[46]

The Swedish Company Act Chapter 8 stipulates specific duties of the board of directors and the managing director. However, not all duties can be determined based on the Companies Act. In addition to the specific duties regulated in law, the directors and the managing director have to comply with a duty of care and a duty of loyalty. As a consequence, the relationship between the company and its management can be described based on the principal-agent model; which is reflected in the fiduciary nature of directors' duties.[47]

3.2 The board's supervisory duty

It is explicitly stated in Chapter 8, Section 4 of the Companies Act that the board has a special obligation to monitor the company's operations. The board must also regularly assess the company's financial position and where the company is the parent company in a group of companies, the group's financial position.

The board of directors' obligation to organise the company's business activities has been concretised by specific requirements in the Companies Act. For example, where certain tasks are delegated to one or several board members, the managing director or other company organs, the board must issue written instructions stipulating requirements about regular reports to the board.[48] These instructions form the basis for the board of directors' supervision of the delegated tasks.[49]

The Swedish Companies Act does not, however, provide precise details regarding the scope of the board's supervisory duty. Hence, the exact scope of the supervisory duty ultimately depends on the organisation and the business activities of the relevant company. Despite the fact that the scope of

[45] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 62.
[46] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 100.
[47] Prop. 1975:103 s. 376-377 and p. 540, Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 63 and 155. Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 60-61. Rolf Skog, Rodhes Aktiebolagsrätt (23rd edn, Norstedts Juridik, 2011), chapter 10.
[48] Companies Act Chapter 8, Sections 4-7.
[49] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 68.

supervision must be determined based on the circumstances in each particular case, general guiding principles can be found in legal literature.[50]

The starting point is that the directors may rely on the information provided concerning the conditions prevailing in the company until something arises which gives them reason to suspect that something is wrong.[51] *Dotevall* points out that the supervision of the company's operations is not static; instead, it must be continuously adjusted to occurring changes.[52] Chapter 8, Section 4 of the Swedish Companies Act requires that the board of directors regularly assess the company's financial position, making the supervisory duty the fundamental obligation of each member of the board irrespective of the degree of actual involvement in the company's business. This requirement is consistent with the current situation and practice, showing that the board of directors in larger companies has a supervisory function.[53]

When it comes to supervising the managing director, correspondingly, the board does not need to scrutinise each and every aspect of the managing director's administration. If the directors have grounds to suspect mismanagement, they need to investigate by e.g. requesting assistance from the company's auditor. The allocation of tasks between the board and the managing director is otherwise such that the board focuses on essential problems in the company's business operations while the managing director is in charge of the daily operation of the company.[54]

3.3 The managing director's duty of day-to-day management

Similar to the board of directors, the provisions of Chapter 8, Section 29 of the Companies Act do not state explicitly that the managing director has an equivalent obligation to monitor the management of the company. However, according to the preparatory works of the previous Companies Act, the obligation arises from the fact that the managing director is responsible for the day-to-day management of the company.[55] Hence, his or her duty is to monitor the company's everyday operations.[56]

The managing director acts under guidelines and instructions from the board of directors. It is therefore mainly the board that decides the scope of duties of the managing director. Although the managing director takes responsibility for a part of the duties otherwise falling under the remit of the board, it should be noted that any large-scale operative decisions remain with the board. This means that when a managing director exists, the board of directors is mainly responsible for the conduct and administration of the business, which is not a part of the everyday operations.[57]

As a consequence, the division of duties between the board of directors and the managing director affects their respective responsibilities. For instance, instructions given by the board of directors could

[50] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 129-133.
[51] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 125.
[52] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 77.
[53] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 129-133.
[54] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 129-133.
[55] SOU 1941:9 p. 324, prop. 1975:103 p. 374.
[56] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 125.
[57] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 63.

be used as evidence later if questions arise regarding the duties and liability of the managing director.[58]

3.4 Division of duties within the board

In order to ensure efficient corporate governance, the board may consider it appropriate to divide duties between the individual directors. The preparatory memorandum to the Companies Act mentions that the division of tasks may be relevant when assessing the extent of a directors' liability: it might result in one director bearing more responsibility than another.[59] Moreover, according to case law, a *de facto* division of tasks between the directors may affect directors' liability, even where it has not formally been agreed upon by the board.[60] Similarly, factors such as the amount of time devoted to the company's affairs or the level of remuneration may also affect the extent directors' liability.[61]

In practice, the division of duties between the board, managing director and the shareholders meetings depend on the articles of association, as well as the size of the company and its operations. Generally, the Companies Act provides a level of flexibility regarding the division of powers between the board and the shareholders.

3.5 Delegation of tasks

Efficient business organisation may require delegation of various tasks e.g. to an executive management committee or other corporate organ.[62] The Swedish Companies Act does not include explicit limitation on the board of directors' and the managing director's power to delegate tasks; such delegation does not affect or limit the board's duty to supervise the execution of the delegated tasks.[63] Instead, extensive delegation increases the supervisory duty correspondingly as the board of directors and or managing director (as applicable) needs to ensure that the essential tasks are performed adequately.[64]

3.6 Duty of care

The duty of care is often discussed in the context of the business judgement rule.[65] Although Swedish law does not formally apply a US-type business judgement rule, case law and legal commentaries acknowledge that risk-taking is characteristic for business and that decisions typically are made under uncertainty.[66] It therefore seems that the application of the general duty of care in Sweden will often lead to similar results as under a US-type business judgement rule when assessing day-to-day

[58] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 125.
[59] SOU 1941:9 p. 633. Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008),. 64. Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 82.
[60] NJA 1974 p. 297, Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 82.
[61] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 65. Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) 83.
[62] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 76.
[63] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 76.
[64] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 76.
[65] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 107.
[66] NJA 2000, p. 404. See also Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 106.

business decisions; a stricter liability standard applies where directors breach specific provisions of the Companies Act.

3.7 Duty of loyalty

While the Companies Act does not explicitly stipulate a duty of loyalty for corporate directors, such a duty is generally derived from the general clause in Chapter 8, Section 41 and the provisions on conflicts of interests in Chapter 8, Section 23 and 34.[67]

Chapter 8, Sections 23 and 34 provides *inter alia* that a board member and a managing director may not take part in matters concerning an agreement between themselves and the company.[68] In such cases there is a conflict of interests irrespective of the content of the contract. In addition, directors and the managing director may not take part in matters concerning an agreement between the company and a third party, where the director or managing director has a material interest which may conflict with the interests of the company.

The general clause (Chapter 8, Section 41) prohibits board members and any other representative of a company from taking any measures which are likely to provide an undue advantage to a shareholder or another person to the disadvantage of the company or any other shareholder. Nor may a representative of the company comply with instructions from the general meeting or any other company organ where such instruction is void due to a violation of the Companies Act, the applicable annual account legislation or the company's articles of association.[69]

The company's interests and the object of the company's operations can be considered equal to those of the shareholders, as a company's purpose is to generate profits to the shareholders.[70] Therefore the requirement of loyalty means equal treatment of all shareholders. A director may not act only for the benefit of the group of shareholders that have appointed the director, but must instead take into account all shareholders equally.[71] If a related party benefits at the cost of the company, a shareholder or a third party, the decision will probably involve at least negligence.

3.8 Adherence to other regulatory laws

In addition to the general duties in the Companies Act, the directors must ensure that the company adheres to other laws applicable to the company; for example the Annual Accounts Act, employee safety regulations, environmental laws and the various tax laws. Listed companies are also subject to a number of additional rules and regulations, compliance with which also falls within the duties of directors.

[67] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 161.
[68] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), pp. 166-167.
[69] Companies Act, Chapter 8, Section 41.
[70] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 168.
[71] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 168.

4 LIABILITY FOR BREACH OF DUTY

4.1 Introduction

4.1.1 General

The Swedish Companies Act includes a specific set of norms that regulate the liability of management, shareholders and auditors towards the company, shareholders and third parties. The Companies Act includes specific provisions regarding liability for damages (Chapter 29) and penalties (Chapter 30), which concern the board of directors and the management's liability towards the company, shareholders and third parties such as debtors based on breach of the Companies Act. Chapter 29, Section 1 states that a member of the board and the managing director shall be liable for the loss that he or she, has in his or her office deliberately or negligently caused to the company through breach of the Companies Act. The same rule applies if the damage is caused to a shareholder or other person. ”Other person” refers mainly to creditors.

The type of situations where a director or the managing director could be regarded as liable is not explicitly regulated in the Companies Act. General principles of tort law will therefore be relevant when evaluating if the duty has been breached and hence liability occurred.[72]

4.1.2 Individual and joint liability

The board of directors is a collegial organ. A director is not entitled to act on his or her own behalf or independently from the meeting of the board of directors. The board member receives information concerning particular issues regarding the company and may raise questions at board meetings, and the task to obtain more information can be allocated to a certain board member.[73]

Despite the fact that the board of directors is a collegial organ, the liability stipulated in Chapter 29, Section 1 is of individual character.[74] As a consequence, a director who disagrees with a decision of the board should make sure that such disagreement is documented in the board meeting minutes.[75] This could be of relevance where the decision taken by the (majority of the) board results in a damage for the company at a later stage.[76] As a general rule, directors who objected to a particular decision, and had such objection properly documented in the minutes, will usually be exempted from liability.[77] This exemption may not apply, however, where the objecting director later participates in the implementation of the relevant decision.[78]

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[72] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), s. 42, Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 62.
[73] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 66.
[74] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008)s. 44. Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 80-81
[75] Companies Act Chapter 8, Section 24.
[76] Rolf Skog, Rodhes Aktiebolagsrätt (23rd edn, Norstedts Juridik, 2011), chapter 8.C.a.
[77] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 86.
[78] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 66.

Despite the individual character of the liability, if more than one board member is liable for the same loss, they are jointly and severally responsible in accordance with general tort law principles. As the Companies Act does not regulate the division of tasks between the directors, the responsibilities of the board and the liability for duties are considered joint and several. Consequently, the Companies Act Chapter 29, Section 6 states that if two or several directors have caused the loss to the company, they are jointly and severally liable.[79] This applies regardless to how much each director has contributed to the loss.[80] There have been views in the literature, however, as mentioned above in section 3.4, that the division of tasks among the board members could have relevance in how the liability is divided between them and therefore the amount of compensation each director is obliged to pay may vary.

4.2 General conditions for liability

4.2.1 Performance of duties

According to the Companies Act, Chapter 29, Section 1, a managing director or a board member is liable only where he or she causes the damage *"in the performance of his or her duties."* Hence, there must be a connection between the damage-causing act or omission by the director or managing director and the business of the company.[81] A director's acts at a board meeting would obviously be fulfilling this condition. If a director or a board member is causing damage to the company – whether actively or by refraining from making a decision he or she would be obliged to make according to the Companies Act – it is also clear that such damage would be qualified as having been caused in the performance of his or her duties.[82] In addition, information he or she receives outside the board meeting may lead to a duty to bring it to the attention of the board if the information is relevant for the business of the company.[83]

4.2.2 Culpability of the director

In Scandinavian jurisdictions, the culpability requirements are usually divided into subjective and objective requirements. The objective requirements relate to the act or omission being contrary to law, whilst the subjective requirements concern the specific circumstances under which the wrongdoer has committed the relevant act (or omission). The objective criteria used for determining a board member's or managing director's liability include the provisions in the Swedish Companies Act, the articles of association as well as obligations typically connected with a similar managerial position.[84]

When determining culpability, circumstances concerning the director as person could be of relevance. Board members are usually heterogeneous, and it is therefore impossible to find a common, lowest acceptable conduct standard that could apply.[85] For instance, it is not required to possess specialist knowledge of the sector in which the company conducts its business to qualify as a director.[86] It is, however, necessary that a director possess a general ability to inform oneself about the business of

[79] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 81.
[80] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 81.
[81] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 54.
[82] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 55.
[83] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 56.
[84] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), pp. 72-73.
[85] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 73.
[86] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 74.

the company. The principle of culpability is based on the fact that a board member should not engage in a role with such responsibility, without having qualifications to do so.[87] According to the legal literature, subjective circumstances and levels of knowledge and experience should be considered when determining a particular director's culpability.[88]

The situation is different in relation to managing directors. Since managing directors typically manage the company on a full-time basis and are responsible for the day-to-day management, the expected standards of expertise, and thus the behavioural expectations, are higher than for non-executive board member.[89]

As mentioned above in Chapter 3.2, the responsibility of the board members may vary depending on, e.g. division of working tasks and the amount of remuneration received by them. In some cases, an expert is appointed as director focusing on his or her certain area in the board's work. Such person will likely carry greater responsibility than the other directors regarding damage or loss which has been suffered by the company within his field of expertise.[90] This view can, however, be disputed on the grounds that the board of directors is a collegial body, and that an individual director shall not bear the primary responsibility for decisions made within a certain area.[91] On the other hand, the allocation of tasks which arises in practice when an expert has been engaged by the board could be argued to reflect the distribution of responsibility.[92]

4.2.3 Requirement of loss

If no loss has been incurred by the company, directors will not be held liable even where they have neglected their duties.[93] In the present context, loss includes any measurable financial loss to the company. The loss can be measured by comparing the hypothetical situation that would have existed if the damage-causing act had not occurred.[94]

Shareholders and creditors of a company may suffer losses in two ways: indirectly, when the company's assets have decreased in value ("reflective loss"), and directly, without the company suffering any loss.[95] The division has relevance only for third parties.[96] A shareholder may, for instance, suffer a direct loss when the principle of equal treatment or some other provision of the Companies Act with purpose to protect shareholders has been breached. A creditor can suffer direct loss by, for example, granting a loan to the company based on incorrect information on the company's financial position.[97] Shareholders will suffer indirect loss when the value of the company's shares decreases.[98]

[87] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 70. Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), 2008 p. 73.
[88] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 72.
[89] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 71.
[90] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 71. Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 76.
[91] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 76.
[92] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 76.
[93] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 52, Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 68.
[94] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 68.
[95] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 79-80. Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 70-71.
[96] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 70.
[97] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 79.
[98] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 79.

The distinction between direct and indirect loss plays an essential role for shareholders and creditors, as the prospects of receiving compensation for the different types of loss vary.[99] A shareholder may directly receive compensation for direct loss under the provisions on damages in the Companies Act Chapter 29, Section 1. Indirect losses, on the other hand, only lead to liability of the director vis-à-vis the company itself.

4.2.4 Adequate causal connection

An adequate causal connection is another prerequisite for liability. If several directors are liable for damage, the causal connection must be determined individually.[100] Each director shall be liable only for the part of the damage caused by him or her. Causality does not arise in conjunction with the neglect of duties by a member of the board or the managing director if the damage would have occurred even if the negligent act had not been committed.[101] Accordingly, for instance, if the managing director fails to perform his supervisory duties concerning employees, liability will be avoided if and to the extent it can be proved that the damage would have occurred even if the supervisory duty had been adequately fulfilled.[102]

Furthermore, in order for liability to attach, it is required that the causal connection is “adequate”.[103] The requirement of adequacy means that certain “remote” causal links between an act or omission and a resulting loss are disregarded so as to avoid excessive liability.[104] In essence, the additional requirement of adequacy defines the *legally relevant* causal links between an act and the resulting damage;[105] the concept prevents excessive liability on the basis that a plethora of actions and circumstances will have *some* causal effect on observable outcomes, even where the cause-effect link is impossible to predict at the time an act or omission occurs.

4.3 Breach of duties

4.3.1 Breach of supervisory duty

According to the Companies Act Chapter 29, Section 1, if a director has neglected the supervisory duty, he or she will generally be responsible for the loss to the company. As mentioned above in Chapter 3.2, the exact scope of the supervisory duty depends on the organisation and the business activities of each particular company and will subsequently have an effect on the scope of liability.[106]

The supervisory duty is typically related to financial circumstances of the company. In general, it can be stated that when a company is in financial difficulties, the board’s duty of supervision will become

[99] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 70-71.
[100] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 65. Svernlöv, p. 73
[101] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 65-66.
[102] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 74-75.
[103] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 74-75.
[104] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 66.
[105] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 66.
[106] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 30-32.

more extensive.[107] However, the scope and extent of the supervisory duty is not only related to financial circumstances of the company, but also to the type of the company's business activities.[108]

Liability may still arise where specific tasks have been delegated by the board members to third parties, since board members and/or managing directors are formally liable for any damage caused by the delegate.[109] However, according to *Dotevall* liability in case of delegation is restricted to cases where board members or the managing director (i) have acted negligently with regard to the selection of the person to whom a task had been delegated; (ii) have inadequately instructed such person; or (iii) were negligent in their supervision of such person.[110]

4.3.2 Breach of duties in day-to-day management

Where the managing director is negligent in performing his or her duties, or where he exceeds his competence as managing director, the managing director is liable for the loss caused to the company pursuant to the Companies Act Chapter 29, Section 1.

The tasks and extent of authority of a managing director, and hence the scope of liability, also depends on the size of the company and the type of its business activities.[111] Certain corporate actions will typically exceed the authority of a managing director acting without a board resolution irrespective of the size of the company. For most companies, this will include the granting of loans of a significant size to third parties.[112] Likewise, the liquidation of a substantial proportion of a company's assets would also be outside the managing directors' authority.[113] In NJA 1958 p. 186, the Supreme Court found that a contract concluded by the managing director regarding acquisition of another business was outside the competence of the managing director because the content, size and the duration of the contract was unusual compared to the scope of the company's operations. In NJA 1968 p. 375, the Supreme Court found that granting a security interest over the company's real estate assets likewise exceeded the managing director's authority.

However, the liability of the managing director has to be seen in a broader context of the principal-agent relationship that the managing director has towards the company. If the managing director had reason to believe that the board of directors would accept his or her decision, and the decision was made in the interest of the company, he or she will normally not be held liable for such actions or decisions.[114]

4.3.3 Breach of duty of care

Directors are also liable if they breach the duty of care. However, it is difficult to concretise the legal scope of the duty of care. Based on the Supreme Court decision in case NJA 1987 p. 394, Dotevall

[107] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 70.
[108] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 125-135.
[109] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 125-135.
[110] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 77.
[111] This is equivalent to the position in relation to the members of the board of directors; see Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 105.
[112] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 105.
[113] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 105.
[114] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 106, 108.

argues that an action has to constitute a serious deviation from the expected business conduct before it can be regarded as a breach of duty of care and lead to liability.[115] Generally, a decision based on appropriate consideration given the circumstances does not necessarily lead to liability simply because of it resulting in a loss.[116] As mentioned above in section 3.5, the result is often similar to the US business judgement rule. Thus, managerial mistakes will not necessarily lead to the directors being liable as long as the decision is within the company's business objectives and provided that the director was not conflicted when making the relevant decision.[117]

The court will for instance not evaluate whether a decision by the board of directors was a good or bad business judgement for the company.[118] In general, if the board has based its decision on information that is, considering the circumstances, sufficient and appropriate, and within the ordinary business of the company, the board of directors will not be held liable by a court.[119] The assessment of the liability of board members or managing director will therefore in most cases be based on whether they have based their decision on sufficiently comprehensive documentation.[120] Regarding sufficient documentation, the amount of documentation depends on the specific situation. For instance, a complicated merger would require more comprehensive information than a short oral report.[121] Moreover, if the board of directors or the managing director have taken decisions that could be damaging for the company, they are obliged to minimize this damage as a consequence of their duty of care.[122]

It is not only positive actions that can constitute a breach of the duty of care and lead to liability. An omission may form the basis of liability in cases where there is an obligation to act. Dotevall outlines the view that omissions in certain circumstances should be treated more strictly than active conduct. This view, originally promoted in American law, has lately been gaining traction in Scandinavian law. As example he describes an omission where the board of directors' fails to act relating to operations of a struggling business segment in order to reduce the losses of the company's creditors.[123] Such an omission would not be covered by the Business Judgement Rule with regard to liability.

4.2.4 Breach of duty of loyalty

4.3.4.1 General

As with the duty of care, it is difficult to concretise the duty of loyalty. However, especially three different forms of cases or situations can be identified in Swedish statutory law, case law, and legal literature as breach of duty of loyalty:

- Where decisions favour one or several shareholders over others, i.e. a breach of the principle of equal treatment of shareholders (section 4.3.4.2 below);

[115] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 110.
[116] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 60.
[117] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 69-70.
[118] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 60.
[119] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 60.
[120] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008),, p. 110.
[121] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 69.
[122] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 111.
[123] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001) p. 70.

- Where a director is acting for the company despite personally having a direct or indirect interest in such a contract (section 4.3.4.3 below); and
- Where a director competes with the company (section 4.3.4.4 below).[124]

4.3.4.2 Equal treatment of all the shareholders

The duty of loyalty includes the duty to treat a company's shareholders equally and fairly. The duty can thus be breached, for instance, if the company enters into a transaction with one of its shareholders at conditions that would not satisfy the arm's length test, e.g. by selling assets at an undervalue to such shareholder.[125]

Another example where a director could be held liable for breach of equal treatment of shareholders is in connection with a non-cash share issuance where payment on behalf of one shareholder is made through property that is undisputedly overvalued.[126]

4.3.4.3 Self-dealing

As mentioned above in Chapter 3.7, the Companies Act Chapter 8, Section 23 provides *inter alia* that a board member or a managing director may not take part in matters concerning an agreement between the director or the managing director, respectively, and the company. Thus, a breach of the duty of loyalty could occur in all cases of self-dealing.

4.3.4.4 Competing with the company

The purpose of the duty of loyalty is to ensure that the directors and the managing director pursues and protects the interests of the company. As a consequence, competing with the company must be seen as a breach of a core part of the duty of loyalty. The relevant director is to be regarded as breaching his or her duty even where the company itself would not have been in a position to pursue the business activity in question.[127]

The duty of loyalty of a director who is not at the same time employed by the company is not equally strong as that of a director who is also employed.[128] However, the Companies Act does not

differentiate between the obligations of directors who are employed by the company and those who only hold mandates in the board.[129] According to Dotevall, this means that even board members who are not employed by the company may not engage in competitive practices.[130] On the other hand, a stronger involvement in competitive practices seems to be required from a board member not employed by the company if such conduct were to constitute a breach of the duty of loyalty.[131]

The concept of *corporate opportunities*, according to which a director owes a duty not to personally exploit business opportunities falling within the broad scope of the company's business activities, is not explicitly regulated or accepted under Swedish law. Swedish scholars do argue, however, that

[124] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 155-184.
[125] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 168-169.
[126] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001), p. 82.
[127] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 176. He argues that the provisions on the conflicts of interest of the Swedish Companies Act Chapter 8 show that competitive practices must be quite extensive to be regarded as representing a breach of the duty of loyalty.
[128] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 176.
[129] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 177.
[130] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 177.
[131] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001), p. 84.

such a duty can be derived from Swedish company law, even if the doctrine is not explicitly regulated.[132]

Dotevall questions whether any difference should be made between companies depending on their size. For instance, he argues that in public companies, board members who are not employed by the company would have certain possibilities to use business opportunities falling within the company's sphere of activities for their own sake. However, if the director is also employed by the company, this will not be permitted. In smaller companies, each case has to be assessed separately.[133]

4.3.4.5 When the director is absent

If a board member has participated in a decision of a principal character at an earlier stage, he or she will unlikely avoid liability if the board makes more concrete decisions in his or her absence in accordance with the earlier decision.[134] Moreover, the duty of a director is that he or she is supposed to actively engage in the company. Repeated absence from the board meetings may therefore also mean that the director has neglected the monitoring duty and may be held liable for damage suffered by the company.[135]

When a permanent member of the board cannot be present, it is necessary to inform a deputy-member.[136] The deputy-member is in general not liable for loss or damage. However, if he or she has participated in the board meeting instead of an ordinary member and participated in the decision making process, the deputy-member could be considered as liable. Liability depends on the level of involvement in the board's work. Dotevall argues that if a deputy-member has been given an opportunity to participate in the meetings and received all the materials possessed by the other board members, he is unlikely to be treated differently than the permanent members of the board in respect of liability.[137]

4.3.4.6 When the director has resigned

The board members and the managing director are only subject to the duty of loyalty as long as they are appointed for their respective position. It is necessary to conclude a contract between the company and the director, if the company wishes to extend this duty after the assignment is terminated.[138] However, in some cases the duty of loyalty also applies after the assignment is terminated. Certain information could, for instance, be subject to confidentiality. This is the case regarding business and trade secrets received as director or managing director and such information may not be used.[139]

4.4 Burden of proof

[132] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 184.
[133] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001), p. 84.
[134] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 78-79.
[135] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 78-79.
[136] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001), p. 67.
[137] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001), p. 67.
[138] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 173.
[139] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 173.

The general rule in Scandinavian law is that the burden of proof lies with the plaintiff. A reversed burden of proof, which lies with the director as in Germany, has not been introduced or embodied in Swedish law.[140] Hence, the burden of proof in the Companies Act Chapter 29, Section 1 lies with the plaintiff.[141] The reason is that directors are thought to end up in unreasonable situations if they had the burden of proof.[142] If the liability is based on other law than the Companies' Act, the burden of proof will need to be assessed accordingly.

4.5 Tort law liability outside the scope of the Companies Act

In cases where the duty of loyalty has been neglected, it could be difficult to draw a borderline between the liability provisions in the Swedish Companies Act and tort liability. This is because the duty of loyalty covers also a board member's behaviour outside the meeting of the board of directors.[143] It is especially difficult to draw a borderline, when the director at the same time has a high position as employee in the company's hierarchy. According to Dotevall, if damage has been caused due to neglect of the duty of loyalty, it should always be treated as breach of the duties under the Companies Act. Typical cases would be where a member of the board disseminates confidential information about the company's affairs, or if he or she engages in competitive practices.[144]

4.6 Discharge of liability

The annual general meeting[145] must be held within six months of the end of the financial year in order to decide on whether to adopt the income statement and balance sheet, and decide on appropriation of profits or losses. At this meeting the shareholders also decide on discharge of liability for board members and the managing director.[146] A decision to discharge a director of his liability means that the shareholders approve of the director's management and thus do not intend to take any actions against the person. If the shareholders decide not to discharge a director from liability it leaves the question whether to take action against him or her open.

If the shareholders decide not to discharge a director from liabilities and the company then decides to bring an action against him or her due to a decision or behaviour during a financial year, it must do so within a year from the presentation of the annual accounts and the annual audit report at the annual general meeting.[147]

Even if the shareholders decide at the general meeting to discharge the directors of their liability it is under certain circumstances still possible to bring action for indemnification against a member of the board. The Companies Act Chapter 29, Section 11 stipulates that it is in any case possible to bring an action for damages if information about the directors decision or behaviour that is the cause for the action has not been included in the annual report or the annual audit report or if the shareholders have not been informed about the decision or behaviour in any other way. The shareholder must in other

[140] Prop. 1997/98:99 p. 187.
[141] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 71.
[142] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008), p. 72.
[143] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001), p. 68.
[144] Rolf Dotevall, Liability of Members of the Board of Directors and the Managing Director (Scandinavian Studies in Law Vol 41, 2001), p. 68.
[145] The annual general meeting is the ordinary general meeting where the annual accounts are to be presented.
[146] Companies Act Chapter 7, Section 11
[147] Companies Act Chapter 29, Section 10, Rolf Skog, Rodhes Aktiebolagsrätt (23rd edn, Norstedts Juridik, 2011), chapter 10.

words have complete and correct information about any circumstance that may be the cause for an action for indemnification before deciding on discharge of liability. It makes no difference if the circumstance in question would normally be included in the annual report or the annual audit report. The legislator's motivation for the rule is that a decision not to bring an action for damages should be valid only if it is based on sufficient information about what the person responsible has done. A part of this information is the auditors' statement, which includes a view on whether the directors may be granted a discharge.[148] Skog points out that the practical result of this rule is that a decision to discharge the board of its liability has no legal consequence at all.[149]

4.7 Limitation of liability

The general rule regarding limitation in the Companies Act Chapter 29, Section 10 states that liable actions carried out either by the board members or the managing director are subject to a limitation period of one year from the date on which the annual report and the auditor's report for such financial year were presented to the general meeting.

However, according to the Companies Act Chapter 29, Section 13 no. 2, when a board member or managing director intentionally or negligently causes damage to the company, which can make them liable in accordance with Companies Act Chapter 29, Section 1, the limitation period is five years.[150]

According to the Companies Act Chapter 29, Section 12, the limitation period is not applicable on damages caused by a criminal act such as fraud, embezzlement or breach of trust. The Criminal Act regulates these cases.

[148] Svernlöv, Styrelse- och VD-ansvar i aktiebolaget 2008, p. 104-105.
[149] Rolf Skog, Rodhes Aktiebolagsrät*t* (23rd edn, Norstedts Juridik, 2011), p 220.
[150] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), pp. 120-121.

5 DUTIES IN THE VICINITY OF INSOLVENCY

One of the most discussed parts of the Swedish Companies Act are Chapter 25, Section 13-20 that deals with lack of capital (*kapitalbrist*), forced liquidation (*tvånglikvidation*) and personal liability.

5.1 Lack of capital

The Companies Act states that if the board has a reason to suspect that the company's assets do not cover more than half of the registered share capital it is obliged to immediately draw up a controlling balance sheet to be reviewed by the company's auditor. If the balance sheet shows that there is a critical lack of capital (*kritisk kapitalbrist*), i.e. the company's net-assets is less than half of the registered share capital, the board has to organise an initial controlling shareholders meeting. This general meeting has three options. The shareholders can decide either to augment the assets in the company to cover the share capital (*kapitaltäckningsåtgärder*), to liquidate the company or that the business shall proceed for a maximum of eight months. If they choose the last option another general meeting has to take place after the end of the eight month period. If at this point the share capital is not entirely covered an obligation arises to liquidate the company.[151]

5.2 Personal liability

If the board does not fulfil its obligations according to the Companies Act within the regulated timeframe, the directors become personally and jointly responsible for the company's obligations that arise during the period that the obligations are not fulfilled.[152]

The Swedish Supreme Court has stated that the analysis to see whether grounds for a personal liability exist should be made in two steps. It is first necessary to control whether an actual lack of capital existed and if the board should have acted as a result of this. It is the claimant who has the burden of proof for this. The director will not be personally liable provided that he or she can prove not having acted negligently.[153]

5.3 Purpose

The purpose of these rules is to protect three interests. The first interest is that of existing creditors. The provisions force the directors to stop the business and liquidate the company while there are still some assets left that can be used to pay back the creditors. Second, an application of the rules acts as a warning to future creditors that there is a lack of capital in the company. Third, it gives the board and the shareholders time to take necessary action before the company becomes insolvent.

[151] Companies Act, Chapter 25, Sections 13-16
[152] Companies Act, Chapter 25, Section 18.
[153] Daniel Stattin, 'Några frågor om personligt betalningsansvar i aktiebolag' (2009-10) 21 Juridisk Tidskrift p. 126.

5.4 Criticism regarding legal framework for lack of capital

The rules in the Companies Act regarding lack of capital and forced liquidation[154] have been strongly criticised in the legal literature. Stefan Lindskog argues that the provisions are an example of awful legislation based on a misunderstanding of the legal position and the effect of the rules, several additions to the provisions and a lack of understanding for the realities of the business community. Despite revisions of the rules several questions are left unanswered and some of the provisions are difficult to apply. It follows that it can be difficult for directors to predict the consequences of certain actions.[155]

Lindskog claims that the provision in the Companies Act Chapter 25, Section 18, which states that anyone who acts on behalf of the company while the board has not fulfilled its duties may become personally liable for any costs the actions occur, can be contradictory. There may be a good reason to act even if this creates certain costs, for example to secure an asset and thus prevent a further degradation of the company's financial situation. This would be in line with a director's duty of care. The outcome of an action may however be difficult to predict and may aggravate the financial situation even if the purpose was the opposite. This rule may thus render the board too passive.[156]

[154] The provisions in Companies Act Chapter 25, Section 13-20 have been presented above in chapter 5.1 of the report.
[155] Stefan Lindskog, *Kapitalbrist i aktiebolag. Kommentar till kap. 25:13-20 ABL* (Norstedts Juridik, 2008), p 17.
[156] Ibid.

6 ENFORCEMENT OF DUTIES

The Companies Act regulates the procedures to be followed when taking action against a board member or managing director in Chapter 29. Chapter 30 in the Companies Act sets forth the sanctions to be applied if the court finds that a board member or managing director has breached the rules in the Companies Act.

6.1 Who has standing to sue

6.1.1 The company as plaintiff

Normally the competent corporate body to file a suit against a third party on behalf of a company is the board of directors.[157] When it comes to damages to the company caused intentionally or negligently by a member of the board of directors or the managing director in accordance with Chapter 29, Section 1 of the Companies Act, the starting point is, however, that the shareholders meeting needs to make the decision to initiate proceedings.

Claims regarding damage to the company may be brought against a director or the managing director when the majority of the shareholders at a general meeting have supported a resolution to bring such a claim or have voted against a resolution to discharge the directors or the managing director from liability.[158] The wording in the Companies Act is such that it is a condition for court proceedings that the issue has been dealt with at shareholders meeting. In the legal literature it is discussed whether the consent by all shareholders to initiate proceedings could substitute a formal handling at a shareholders meeting as the purpose is to protect minority shareholders. Svernlöv concludes that it is considered doubtful how the courts would view such substitute. When the proceeding is initiated on behalf of the company, the matter needs to be dealt with at the shareholders' meeting first.[159]

6.1.2 The shareholders as plaintiffs

Under Swedish law, not only a majority of the shareholders may initiate proceedings for damage incurred by the company due to breach by a board member or managing director. According to Chapter 29, Section 7 of the Companies Act, a minority consisting of shareholders owing not less than one-tenth of all shares in the company, can also initiate proceedings in the company's name provided that they, at a general meeting, have supported a resolution to bring such a claim in damages or have voted against a resolution to discharge the directors or the managing director from liability.

Further, minority shareholders representing at least one-tenth of all shares in the company may also convene an extraordinary general meeting in accordance with the Companies Act Chapter 7, Section, 13, Sub-section 2 in order to deal with the issue.

[157] Companies Act, Chapter 8, Section 4 and The Code on Judicial Procedure (*Rättegångsbalk*en (1942:740)) Chapter 11, Section 2.
[158] Companies Act, Chapter 29, Section 7.
[159] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p. 90.

In addition to the right to initiate proceedings on behalf of the company, minority shareholders representing at least one-tenth of all shares in the company may also initiate proceedings for damage to the company in their own name pursuant to Chapter 29, Section 9. The basic principle is that the shareholders who have initiated proceedings in their own name are liable for the costs arising in connection with the proceedings but in case the suit is successful, they have a right to compensation from the company to the extent the costs are not covered by the counterparty.[160]

6.2 Criminal and administrative sanctions

6.2.1 Companies Act

Chapter 30 in the Swedish Companies Act regulates penalties and conditional fines for breach of certain provisions of the Companies Act. Chapter 30, Section 1 states that fines or imprisonment up to one year shall be imposed on any person who has breached the following provisions of the Companies Act:

- Intentionally violates the provisions of Chapter 1, Sections 7 or 8 (prohibition on sale of shares, etc. in private companies);
- Intentionally or through negligence fails to maintain a share register or to make such share register available;
- Intentionally or through negligence violates the provisions of Chapter 8, Section 18 (board meeting not convened despite request by director or managing director), Section 20 (deputy members for employee representatives appointed pursuant to the Private Sector Employees Board Representation Act have not been informed) or Section 21 (board resolution adopted without all directors afforded opportunity to participate and received sufficient information); or
- Intentionally or through gross negligence violates Chapter 21, Sections 1 (loan to related party), 3 (granting security to related party), 5 (loan for acquisition of shares in company or parent company) or 10 (obligation to yearly prepare schedule of loans).

6.2.2 Criminal liability

The Swedish Penal Code (Brottsbalken (1962:700)) regulates criminal liability. Chapter 10 regulates embezzlement and other breaches of trust which typically includes a breach of fiduciary duty of a board member or managing director. According to Section 5:

- A person who, by reason of a position of trust has been given the task of managing another's financial affairs or independently handling an assignment requiring qualified technical knowledge, or exercising supervision over the management of such affairs or assignment, abuses his position of trust and thereby injures his principal, shall be sentenced for breach of faith committed by an agent against his principal to a fine or imprisonment for at most two years.

According to established legal principles in Swedish law, only physical persons can be held criminally liable. Legal entities cannot incur criminal liability. For example, if a company makes illegal payments, the physical persons who participated in the corrupt activity, such as board members, are liable.

[160] Carl Svernlöv, Styrelse- och VD-ansvar i aktiebolaget. En introduktion. (Norstedts Juridik 2008), p.95-96.

7 CONFLICT OF LAWS

7.1 Classification under Sweden's private international law

7.1.1 Company law

A legal person's nationality is determined in accordance with international private law principles. Sweden follows the incorporation theory when it comes to determining the law applicable to companies. The Companies Act does not include an explicit definition of a limited liability company but it is considered clear that a limited liability company means a company established according to the rules in the Companies Act. A limited liability company incorporated in accordance with the Swedish Companies Act and registered in the Swedish Companies Register (*aktiebolagsregistret*) is thus governed by the Swedish Companies Act. The Companies Act is not applicable on companies established under foreign law.[161]

According to the Companies Act, a company's articles of association (which are registered in the Companies Register) must include information on the region in Sweden where the company's board has its seat.[162] The registered seat is not comparable with the real seat as used in the real seat theory. The Companies Act does not require that the company's headquarter is in Sweden or that any business is conducted in Sweden.[163] Only "some natural connection" to the registered seat is, according to the Companies Register's practice, required. A correspondence address for the company must also be registered but the correspondence address can be located abroad.

Based on the general structure of the Companies Act, it is not considered possible for a Swedish company to change nationality as such. In certain cases a change of nationality is possible i.e. through a cross-border merger or if the business of the company is transferred to a European Company (SE) in connection with the formation of a SE in accordance with Regulation (EC) No 2157/2001.[164]

7.2 Relevant rules of private international law

7.2.1 Company law

As described above in 7.1.1, Sweden uses the incorporation theory to determine the law applicable to companies. The company's domicile (the registered seat in the Companies Register) sets forth the competent court in matters relating to the company.

[161] Andersson et al. Aktiebolagslagen, en kommentar (2011).
[162] Companies Act Chapter 3, Section 1 (2).
[163] Andersson et al. Aktiebolagslagen, en kommentar (2011).
[164] Andersson et al. Aktiebolagslagen, en kommentar (2011).

Although a liability case (based on the Companies Act) against a board member would normally be handled at the court where the company has its domicile, if the board member is not residing in Sweden, it may follow from Sweden's commitments in international agreements that he or she can't be brought into court there.

The principle following from the Council Regulation (EC) No 44/2001 of 22 Dec 2000 ("Brussels I") on jurisdiction and the recognition and enforcement of judgements in civil and commercial matters is that jurisdiction is to be exercised by the EU country in which the defendant is domiciled, regardless of his or her nationality.

7.2.2 Tort law

In tort law, Regulation (EC) No 864/2007 (Rome II) applies. Thus, the law of the country in which the damage occurs is applicable unless there is a closer connection with another country (art. 4(1), (3) Regulation (EC) No 864/2007).

7.2.3 Insolvency law

International insolvency law is regulated by Regulation (EC) No 1346/2000. According to art. 4(1) of the Regulation the law of the state applies where the insolvency proceedings are opened.

DIRECTORS' DUTIES AND LIABILITY IN UNITED KINGDOM

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CONTENTS

1 INTRODUCTION

1.1 Corporate law and directors' duties in UK

Company law in the UK is found in the Companies Act 2006 and a body of common law cases. In addition, companies in the UK – depending on the nature of the company – are subject to additional rules and regulations set forth, for example, in the UK Corporate Governance Code, The Takeover Code and the Listing Rules.

1.2 Corporate landscape in UK

The Companies Act regulates both how companies are to be formed and also how they are to be run. The Act represents the largest piece of legislation ever enacted in the UK, with forty-seven parts and a total of one thousand three hundred sections and sixteen schedules which are also supplemented by a number of Statutory Instruments. In contrast to previous Companies Acts, the 2006 Act is more accessible in style and structure. For example, whilst the Act governs both private and public companies, which are mainly treated exactly the same, where there are different requirements, this is clearly set out separately in the Act.

In addition to the Act, another key legislative provision is the *Model Articles for Public Companies*[1] with separate Model Articles applying to private companies. The Model Articles are prescribed by the Secretary of State, providing additional guidance to companies and applying to a company if it has not provided its own articles or where its own articles do not cover a particular subject.

Aside from these key provisions, the sector or activity of the company may determine whether particular provisions of the Companies Act apply to it and whether it is subject to other forms of regulation, such as banks and insurance companies, which are regulated by the FSA.

One example of specific regulation is the UK Corporate Governance Code, which was issued in its newest version by the Financial Reporting Council (FRC) in June 2010 and applies to premium listed companies. The code contains a statement of best practice in relation to the composition and work of a board of directors of a company with publicly traded shares. Whilst the code itself is not binding, listing rules for the Stock Exchange require an annual statement of how a listed company has applied the main principles of the code. This statement should explain whether the company has complied with the principles and give reasons for non-compliance.[2]

[1] Statutory Instrument 2008/3229.
[2] Listing Rule 9.8.6R (6).

1.3 The board of a UK company

Section 154 (2) of the Companies Act requires that every public company must have at least two directors whilst every private company should have at least one director.[3] In a public company, if there is only one director, this director cannot act except to appoint a sufficient number of directors, which is prescribed in Article 11 of the *Model Articles for Public Companies*.

In the UK, there is no distinction in law between executive directors (involved in day-to-day business) and a non-executive director. Associated with this, there is no two-tier structure as non-executive and executive directors both participate equally in board meetings. In spite of the lack of formal legal distinction between executive and non-executive directors, as Langley J accepted in *Equitable Life Assurance society v Bowled,*[4] whilst the duties owed by a non-executive director will be the same as the duties owed by an executive director, in application the duties (in particular the duty of care) may differ to take account of the different role and function of the non-executive director.

In contrast to the statutory requirements under the Companies Act, which does not distinguish between executive and non-executive directors, the Combined Code for listed companies does. For listed companies, the Corporate Governance Code states that there should be an appropriate combination of executive and non-executive directors, and in particular, independent non-executive directors.[5] It further stipulates that the independent non-executive directors should be listed in the annual report and the board should decide if they are independent according to seven factors listed in the supporting principles B1.1. If a company is part of the FTSE 350 index, at least half of the directors should be independent.[6] The UK Corporate Governance Code gives a special role to the independent non-executive directors by recommending that they should form the majority of the nomination committee recommending director appointments, and remuneration and audit committees should be composed exclusively of non-executive directors.

[3] S154 (1).
[4] [2004] 1 BCLC 180 at Para 35.
[5] Supporting principles B1.
[6] B1.2.

2 THE CONCEPT OF 'COMPANY DIRECTOR' IN THE UK

Section 250 of the Companies Act 2006 defines a director as "any person occupying the position of a director by whatever name called". This is exactly the same definition that has been used in successive Companies Acts since 1908. This represents an intentional policy motivation to retain the open definition, to ensure that the term is applied to everyone exercising real decision-making power within a company, which is why there has been no effort to give a more detailed definition in the new Act. Within the definition of a director, it is possible to distinguish between *de iure* directors, *de facto* directors, and shadow directors.

2.1 De iure directors

The requirements to be classified as a *De iure* director are:

1. The director has been appointed to the office of director according to rules governing this;
2. The person has agreed to hold office;
3. The person is not disqualified from being a director; and
4. The person has not vacated office.

In appointing a *de iure* director, it is possible for another company to be appointed as a director, as first introduced by *Re Bulawayo Market and Offices Co Ltd*.[7] However, section 155(1) of the Companies Act 2006 has introduced a new rule that there must be at least one director who is a natural person.

2.2 De facto and shadow directors

A person who acts as a director but is not a *de iure* director is a *de facto* director. Whether someone is a *de facto* director depends on the context.[8] Until the 1980s this meant someone who had been appointed but there was some error regarding their appointment or a situation where someone continued to act as a director after their office had been terminated. However, more recently the interpretation has widened and includes those who have never been officially appointed according to recent case law. The term *de facto* director was discussed in detail by Lord Collins in the Supreme Court case *Commissioners HM Revenue and customs v Holland.*[9] Lord Collins indicated that there are different meanings in different contexts where the term can be invoked.

The Companies Act defines a shadow director as "a person in accordance with whose instructions or directions the directors are accustomed to act"[10] but this does not refer to a person who gives advice

[7] [1907] 2 Ch 58.
[8] *Re Lo-Line Electric Motors* [1988] [1988] Ch. 477.
[9] [2010] 1 W.L.R. 2793.
[10] Section 251(1).

in a professional capacity.[11] In practice, the courts have interpreted this to mean that at least a consistent governing majority of the directors must be accustomed to act in that way.[12] This is a strict standard, as the Court held in *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd*[13] that the requirement is not satisfied where only a minority of the directors are accustomed so to act.[14] Also, as the Court specified in *Re Unisoft Group Ltd (No 3)* the directors must actually act on the person's instructions and directions regularly over a period of time.[15]

Furthermore, there may be a period before a person becomes a shadow director when directors act in accordance with the person's directions and instructions but are not yet accustomed so to act.[16] Some further guidance was given in the case of *Secretary of State for Trade and Industry v Deverell*[17] where it was deemed that it is not necessary to show that a person gives directions on every matter that the directors act, but it must be shown that the person has a real influence. The determining factor as to whether any particular communication should be classed as a direction or instruction is for the Court to decide upon objectively.

Overall, it is apparent that there is a very demanding standard in establishing that someone is a shadow director.

[11] Section 251 (2).
[12] *Ultraframe (UK) v Fielding* [2005] EWHC 1638 (Ch), LTL 11/08/2005 at 1272.
[13] [1991] 1 AC 187 at p.223.
[14] See also, *Lord v Sinai Securities Ltd* [2004] EWHC 1764 (Ch) [2005] 1 BCLC 295.
[15] [1994] 1 BCLC 609 at p.620.
[16] *Ultraframe*, cited above, at 1273-1277.
[17] [2001] Ch 340.

3 THE SCOPE OF DIRECTORS' DUTIES UNDER UK LAW

3.1 Types of directors' duties

English law takes a shareholder-centred view of the company, as demonstrated for example, in the UK Corporate Governance Code which sets out principles of corporate governance in the interests of shareholders. Directors are seen as stewards of the shareholders. Companies are formed and managed by directors for the benefit of shareholders and this purpose is achieved through fiduciary obligations and a duty of care and skill, with remedies available for a breach. This traditional relationship between directors and shareholders is described by Lord Oliver in *Caparo plc. v Dickman*.[18]

This approach can be traced back to the 19th century when it used to be said that directors were trustees of the company's property. This is still in evidence in the context of the *Insolvency Act 1986*, in particular in section 212 which provides for "misfeasance proceedings" to be taken against any past/present officer of a company in liquidation. Before 1986, misfeasance proceedings could be taken for any "breach of trust". However, unlike trustees in reality, directors of a company do not hold the legal title to the company property. As Lord Porter said in *Regal (Hastings) Ltd v Gulliver*,[19] "directors, no doubt, are not trustees, but they occupy a fiduciary position towards the company whose board they form." The misfeasance provision has now been re-worded and instead a breach of trust now refers to "breach of fiduciary or other duty".

The law on director duties has been transformed by the Companies Act 2006, which codifies these duties for the first time. The seven new general duties are prescribed in sections 171-177 and are based on the equitable principles relating to fiduciary duties and the common law of negligence. The courts will determine the extent to which the duties apply to shadow directors.

The seven general duties are:

- Duty to act within powers;
- Duty to promote the success of the company;
- Duty to exercise independent judgement;
- Duty to exercise reasonable care, skill and diligence;
- Duty to avoid conflicts of interest;
- Duty not to accept benefits from third parties; and
- Duty to declare interest in proposed transaction or arrangement.

[18] [1990] 2 AC 605, 630 HL.
[19] [1967] 2 AC 134.

Section 170(3) states that the general duties specified in sections 171-177 “are based on certain common law rules and equitable principles as they apply in relation to directors and have effect in place of those rules and principles as regards the duties owed to a company by a director.”

However, the interpretation of the duties is guided by section 170(4) which states that “the general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties.”

It is thus clear from this wording of section 170(4) that the court will continue to develop the principles of fiduciary duty and negligence as they apply generally, as the codification risks losing this adaptability in exchange for the certainty of fixed statutory provisions. In considering this wording, it appears quite novel. One commentator goes as far as suggesting that this is a new way of interpreting a statute and it will be interesting to see how the courts take to it as he believes that sections are more akin to principles in a leading judgment rather than statutory rules.[20] Section 178 also provides that the remedies for breaches of the principles set out in sections 171-177 are to be the same as for corresponding common law or equitable principles.

3.1.1 Fiduciary duty

Fiduciary principles refer to trust and confidence. A fiduciary is someone who acts for, or on behalf of someone, in a relationship of trust and confidence, which equity protects by imposing the fiduciary duty of loyalty.[21] Some relationships are always of a fiduciary nature including the relationship between a director and a company. The strongest fiduciary duty is owed by a trustee. Directors are not trustees in the strict legal sense, as they do not have the legal title to the property, but they bear trustee-like responsibilities as they have the power and duty to manage the business in the interests of the company.

The characteristic feature of a fiduciary duty is that remedies provided by equity for a breach of this duty are designed to deter breaches rather than compensate for loss. The primary remedy for a breach of a director’s fiduciary duty is to confiscate the profit made by the director arising from a breach and hand it over to the company regardless of whether the company suffered any actual loss.

In equity, a breach of a fiduciary duty is described as “fraud” even where there is no dishonesty or recklessness. Accordingly, this concept of fraud is much wider than that in common law, as discussed in *Derry v Peek*.[22] Fiduciary duties are owed by *de iure* directors and persons who act as directors but have not been formally appointed. They are not owed by someone elected a director who has not taken up their position yet.

Fiduciary duties are owed by directors by virtue of being directors, but are owed to and can only be enforced by the company. The director does not owe any fiduciary duties to shareholders,[23] creditors[24] or fellow directors.[25]

[20] Simon Mortimore, *Company Directors: Duties, Liabilities and Remedies*, OUP 2009, p.479.
[21] *Bristol and West Building Society v Mothew* [1998] Ch 1 Millet LJ at p.18.
[22] [1889] 14 App Cas 337.
[23] *Brand Investments ltd v Keeprite Inc* [1991] 80 DLR 94th) 161.
[24] *Re Wincham Shipbuilding* [1878] 9 ChD 322.

Some people argue that it is not appropriate to apply the concept of fiduciary duty derived from the concept of a trustee to directors, as trustees are supposed to be prudent, risk adverse and preserve assets of a trust. On the other hand, directors are supposed to be risk-taking entrepreneurs. In response, it can be argued that the prohibition of risk is not central to the law on fiduciary duties as the courts have consistently said that they will not judge the commercial sense of a director's decisions.

3.1.2 Duty to act within powers

Section 171 states that a director of a company must:

(a) Act in accordance with the company's constitution, and

(b) Only exercise powers for the purposes for which they are conferred.

This is based on the equitable principle of the duty to exercise power for the purposes they were given. Sometimes limits of exercise of power can be found in the company's articles. Often they are not prescribed in advance and therefore every case will depend on the facts and context. In practice the duty set forth in section 171(b) has been used to regulate the exercise of board power when it interferes with fundamental shareholder rights such as voting rights.[26]

3.1.3 Duty to promote success of the company

Section 172 states that:

1. A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
    a. The likely consequences of any decision in the long term,
    b. The interests of the company's employees,
    c. The need to foster the company's business relationships with suppliers, customers and others,
    d. The impact of the company's operations on the community and the environment,
    e. The desirability of the company maintaining a reputation for high standards of business conduct, and
    f. The need to act fairly as between members of the company.
2. Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.
3. The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

[25] *Kohn v Meehan* [2003] LTL 4/6/2003.
[26] *Howard Smith v Ampol Petroleum* [1974] AC 821.

This duty is based on the equitable fiduciary duty formulated in combination with the duty to act within powers as articulated by Lord Greene in *Re Smith and Fawcett*.[27] As Arden LJ further described in *Item Software (uk) Ltd v Fassihi*:

> …the fundamental duty to which a director is subject, which is the duty to act in what he in good faith, considers to be in the best interests of the company…The duty is expressed in these very general terms. But that is one of its strengths: it focuses on principle not on the particular words which judges or the legislature have used in any particular case or context. It is dynamic and capable of application in cases where it has not previously been applied…it reflects the flexible quality of the doctrines of equity. [28]

In applying the test, the courts will look at the way that the director considered in good faith what was most likely to promote the success of the company and not the way that the court itself considers would have been most successful. A decision arrived at honestly, even when the belief was wrong, does not breach this duty.

Furthermore, even where the directors have not separately considered the company's interests, action may still not be considered in breach of fiduciary duty if it satisfies the objective test formulated by Pennycuick L in *Charterbridge Corp Ltd v Lloyds Bank*,[29] which states:

> The proper test, I think, in the absence of actual separate consideration, must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the extenuating circumstances, have reasonably believed that the transactions were for the benefit of the company.

As part of this requirement, directors must consider interests of employees under section 172(1)(b), but only in the context of the benefit to shareholders. This is in contrast to the previous provision in the Companies Act 1983, section 309, where directors were to have regard to employees in general as well as shareholders. However the Company Law Review Steering Group in its report *Modern Company Law for a competitive economy: the strategic framework* (DTI 1999) believed that section 309 should be repealed as it threatened the principle of shareholder primacy and would have allowed directors to prefer employee interests to shareholders. Traditionally, the interests of employees have not featured much in British company law.

3.1.4 Duty to exercise independent judgment

Section 173 imposes a duty to exercise independent judgment. This statutory duty reflects the equitable principle that directors are required to act in what they believe is in the interests of the company. The ability to act in the best interest of the company would be eliminated if the director was bound to follow external directions. However, specified restrictions on the directors' discretion may be permissible if necessary in order to secure an advantage for the company, for example an important transaction.[30]

[27] [1942] Ch 304.
[28] [2004] EWCA Civ 1244.
[29] [1970] Ch 62 at p.74.
[30] *Fulham Football Club v Cabra Estates plc* [1994] 1 BCLC 363.

3.1.5 Duty to exercise reasonable care, skill and diligence

Section 174 stipulates that:

1) A director of a company must exercise reasonable care, skill and diligence.
2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with—
   a) The general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
   b) The general knowledge, skill and experience that the director has.

Section 174 requires a dual objective/subjective standard for statutory duty of care, skill and negligence. Subsection a) is the objective standard and b) is the subjective standard. The traditional understanding of the earlier duty of care cases is that they required only a “subjective” standard requiring reasonable care assessed through a hypothetical director who had the skills, knowledge and experience of the actual director.[31]

However, at the end of the 20th century, the courts adopted a dual objective/standard test influenced by the *Insolvency Act 1986*’s provisions on wrongful trading.

As regards to the knowledge element, the Court of Appeal in *Re Barings plc (No 5)*[32] agreed with the statement at first instance that “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 to properly discharge their duties as directors.” Furthermore, whilst directors are allowed to delegate functions to employees there is still a duty to supervise the discharge of functions.[33]

In relation to negligent liability for acts committed by other officials in the company, the courts have long recognised that directors must rely on other employees to inform them of what is occurring in the company. In *Dovey v Cory*[34] it was recognised that the duty should not extend to acts of every degree committed by employees as it would be impossible for the business to function if directors were expected to monitor every act carried out in the business, and directors are justified in trusting officials to carrying out duties honestly. However, directors have supervisory duties. As was held in *Re Barings Plc (No 5)*,[35] there can be no universal rule of application as the extent of the supervisory duty will depend on the facts of the particular case, including the particular director’s role in the management of the company. In *Re Queens Moat House (No2)*,[36] in applying the dual objective/subjective standard of care, it was held that the duty of the defendant as chairman and joint managing director to question accounts prepared by its finance director, who was a qualified accountant, was limited to matters which would have been apparent to a man of the chairman’s business experience and knowledge. However, the defendant did not have a duty to check the performance of functions delegated to the finance director which were properly within the expertise of an accountant and which the defendant had no reason to presume were not being properly performed.

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[31] *Lagunas Nitrate co v lagunas syndicate* [1899] 2 Ch 392, 435 Court of Appeal.
[32] [2000] 1 BCLC 523.
[33] [1999] 1 BCLC 433, confirmed [2000] 1 BCLC 523 (CA).
[34] [1901] AC 477.
[35] [1999] 1 BCLC 433, confirmed [2000] 1 BCLC 523 (CA).
[36] [2004] EWHC 1730 (Ch), [2005] 1 BCLC 136.

3.1.6 Duty of loyalty

Section 175 specifies that a director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. This applies in particular to the exploitation of any property, information or opportunity.

Section 175 is based on two equitable principles: the no conflict and no profit rules. The fundamental principle was stated in *Bray v Ford*[37] by Lord Herschell: A person in a fiduciary position is not allowed to make a profit, nor put themselves in a position where interest and duty conflict.[38] This applies in particular to the exploitation of any property, information or opportunity. Under the equitable corporate opportunity doctrine, there is a breach of fiduciary duty if a director pursues an opportunity for their own benefit when the opportunity belongs to the company.[39]

Under the common law rule, shareholders had to approve the transaction of the directors, or the directors would be accountable to the company for the profit they had made from exploiting the business opportunity. Section 175(5)-(6) now provides for an additional, alternative, mechanism to validate the transaction. The conflicted director does not breach the duty of loyalty if the disinterested directors authorise the transaction, i.e. give their permission *ex ante*.[40] In public companies, the constitution must enable the directors to authorise the matter whereas in private companies the default rule is that authorisation by the directors is permissible.[41]

3.1.7 Self-Dealing

Section 177 of the Companies Act 2006 stipulates that if a director transacts with his company, the transaction will only be valid if he declares the nature and extent of his interest to the other directors in advance of the company entering into the transaction. If a director makes the required declaration, the transaction is valid and does not require approval by the company's members.

According to section 177, when the board of directors decides on the transaction after disclosure, the interested director does not need to abstain from voting. However, the Model Articles provide that the interested director shall not be counted as participating in the meeting for quorum or voting purposes.[42] If the director fails to declare his interest, the civil consequences are determined by the common law in force before adoption of the Companies Act 2006.[43]

There is also an obligation of continual disclosure, which provides that the director continues to be subject to the duty to make full disclosure after the company has entered into the transaction.[44]

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37 [1896] A.C. 44.
38 See further, G Jones, '*Unjust enrichment and the fiduciary's duty of loyalty*' [1968] 84 LQR 472.
39 *Cook v Deeks* [1916] 1 AC 554.
40 Pursuant to s. 175(6), the conflicted director may participate in the board meeting, but he and any other interested director count neither for purposes of quorum nor voting. Note that s 175(6) distinguishes between 'the director in question' (who intends to make use of the corporate opportunity) and other interested directors, who are also barred from voting. The provision does not define, however, when a director is interested in another director's business opportunity. For a discussion of this point see P L Davies, *Gower and Davies' Principles of Modern Company Law*, 8th ed, Sweet & Maxwell 2008, 16-69.
41 Section 175(5).
42 Art 16 Model Articles for Public Companies, Art 14 Model Articles for Private Companies.
43 See Companies Act 2006, ss 178(1), 180(1).
44 Companies Act 2006, s. 182.

Violation of the continuing disclosure obligation results in criminal liability.[45] Common law rules can be found in *Aberdeen Railway Company v Blaikie Bros*.[46] The House of Lords stated in that case:

> It is a rule of universal application that no one, having [fiduciary] duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect. So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into.

In Aberdeen Railway the contract was made void with the railway company, but the case did not give guidance as to whether the shareholders can permit directors to go ahead with transactions in such cases. The approval by the shareholders may be given either *ex ante* (consent or authorisation)[47] or *ex post*, i.e. after the director has breached his duty by inducing the company to enter into the transaction (ratification).[48] Alternatively, such permission can be prescribed in the articles. The shareholders' approval may also be given by resolution of the general meeting and relate to a specific transaction.

Before the Companies Act 2006, it was not always clear which of these were valid. However, it was apparent in the case law that the courts were prepared to be flexible in applying the rule in *Aberdeen Railway* with regard to the articles of association as seen in the decision in *Imperial Mercantile Credit*,[49] where Lord Hatherley stated:

> …The rules of the company seem to prescribe a mode of proceeding by which they exempted this particular case from the operation of the general rule of the Court of Equity, and it appears to me that Mr. Coleman sufficiently complied with that rule when he made it clear to all the persons (and they all admit that he made it clear) that he had an interest…

As a result of the Companies Act 2006, it is clear that such authorisation by shareholders is enforceable.

3.2 Application of duties to de facto and shadow directors

As regards to whether the general duties apply to shadow directors, section 170(5) of the Companies Act stipulates that "the general duties apply to shadow directors where and to the extent that the corresponding common law rules or equitable principles so apply." There is very little case law on this so far. The mere fact that a person, not being a *de iure director,* falls under the statutory definition of a shadow director is not enough for a fiduciary duty to be imposed, as confirmed in *Ultraframe (UK) Ltd v Fielding*.[50] So it is up to the court to decide what fiduciary duties are owed by shadow directors on a case by case basis.

[45] Companies Act 2006, s. 183.
[46] [1854] 1 Macq 461.
[47] See now Companies Act 2006, s. 180(4)(a).
[48] See now Companies Act 2006, s. 239.
[49] *Imperial Mercantile Credit* Association v Coleman (1870-71) L.R. 6 Ch. App. 558.
[50] [2005] EWHC 1638 Ch at 1284 and 1289.

4 LIABILITY FOR BREACH OF DUTY

4.1 Fiduciary duty: conditions for liability

The liability for a breach of the general duties outlined in sections 171-177 of the Companies Act are the same as would apply if a breach occurred of the corresponding equitable principle or common law.

The principle objective of an action for a breach is to deter directors and not to compensate the company for the loss. In order to obtain a remedy for a breach of fiduciary duty, it is not necessary to show that the director acted dishonestly or in bad faith.

It is possible that the courts may award an equitable allowance for the breaching director's good faith efforts. However, following the decision in *Guinness plc v Saunders*[51] courts are unlikely to make such awards.

4.2 Exemptions and limitations

4.2.1 Ratification and court's power to relieve director of liability

There are two ways in which a director may be relieved from liability when there is a breach of a duty to the company. The company may give permission in advance (*ex ante*) for the director to act before the conduct occurs, which is known as authorisation, or after the conduct occurs, which is known as ratification. In addition, if the company does bring a claim where either authorisation or ratification has not been given, the court may still relieve the director of liability at its discretion under section 1157 of the Companies Act where the court finds that the act was honest and reasonable.

Section 239 of the Companies Act is a new provision which reforms the law in refining the circumstances where a company can ratify. The provision restricts ratification to situations where shareholders reach a decision that is independent of the wrongdoer and provide consent. The section does not alter the law relating to acts or omissions of directors that are incapable of being ratified. However, if the conduct is capable of being ratified the section gives shareholders either unanimously or by resolution the power to decide whether to relieve the director of liability. If they do decide to do this, they are strictly bound by this decision and there is an absolute bar on continuing a derivative action.[52]

Therefore, so long as a decision to ratify subsists, the director is safe from proceedings by the company or a derivative action. However, as one commentator has noted, it is not entirely clear whether the decision of a company to ratify is on its own sufficient to protect the director at all times. One example, cited in a leading text,[53] suggests that following a change of control or insolvency, the company may change its mind and wish to sue the director, in which case a director may be well

[51] [1990] 2 AC 663.
[52] Section 263 (2) c (ii).
[53] See Simon Mortimore, *Company Directors: Duties, Liabilities and Remedies*, OUP 2009, p.461.

advised to obtain a deed of release or enter into a compromise agreement including a release of claims.[54]

However, there are two situations where acts cannot be rectified. First, acts committed which go beyond the powers of the company. Given the unrestricted objects of a modern company, this will seldom arise. Secondly, historically fraudulent transactions were also excluded from ratification.[55] However, fraud necessarily always involves a victim who may be the company itself or constituents, i.e. shareholders or creditors. This may thus be reconsidered in light of section 239, as there appears to be no reason why fraud cannot be ratified if all the shareholders agree, where the defrauding is against the shareholders themselves. More often, it is the creditors who are the victims of fraud. In this case the members have no power to authorise or ratify the directors' conduct.[56]

Even in cases where the shareholders do not ratify or authorise a breach of a duty, the courts have the discretion to relieve the director of liability if they acted honestly and reasonably as seen in the *Coleman Taymar ltd v Oakes* case.[57] This longstanding provision is now codified in the Companies Act in section 1157.

4.2.2 Contracting out of directors' duties

In *Re City Equitable Fire*[58] although the directors were found to have breached their duties the terms of appointment of the directors (contained in the company's articles) provided that the company would indemnify and hold harmless the directors for any loss or damage incurred in the performance of their duties. The Court held that such a provision was enforceable. In response to this case, section 78 of the Companies Act 1928 was enacted to limit the possibility to contract out of directors' liability. Under the current legislation, section 232 of the Companies Act declares void any such provision unless it qualifies for the indemnity provisions contained in sections 233-235. Section 232 states:

1) Any provision that purports to exempt a director of a company (to any extent) from any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company is void.
2) Any provision by which a company directly or indirectly provides an indemnity (to any extent) for a director of the company, or of an associated company, against any liability attaching to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company of which he is a director is void, except as permitted by—
    a) Section 233 (provision of insurance),
    b) Section 234 (qualifying third party indemnity provision), or
    c) Section 235 (qualifying pension scheme indemnity provision).
3) This section applies to any provision, whether contained in a company's articles or in any contract with the company or otherwise.
4) Nothing in this section prevents a company's articles from making such provision as has previously been lawful for dealing with conflicts of interest.

54 Ibid.
55 *Welham v DPP* [1961] AC 103, 123 HL.
56 *Rolled steel v British Steel* [1986] Ch 246 at 296, Court of Appeal.
57 [2001] 2 BCLC 749.
58 [1925] Ch.407.

4.2.3 Limitation periods

The normal limitation period for breach of fiduciary duty is 6 years unless the provisions of the *Limitation Act 1980* section 21(1) apply, where there is no limitation period. The provision stipulates:

1. No period of limitation prescribed by this Act shall apply to an action by a beneficiary under a trust, being an action—
    a. In respect of any fraud or fraudulent breach of trust to which the trustee was a party or privy, or
    b. To recover from the trustee trust property or the proceeds of trust property in the possession of the trustee, or previously received by the trustee and converted to his use.

4.3 Insurance against liability

Section 232(2) deals with indemnifying liability through insurance. This provision permits but does not make compulsory the possibility to purchase Directors and Officers liability insurance for a director against any liability for negligence, default, breach of duty or breach of trust. The policy rationale for allowing this is evident in the *White Paper Company Law Reform 2005*, which considered that there needs to be a careful balance between, on the one hand, the need to deal fairly with wrongs, whether dishonest or negligent, and on the other hand, the need not to deter highly skilled people to actually become directors.[59]

Usually the cover will extend not only to the amount of a judgment or settlement, but also to the legal costs incurred by the insured individual in defending claims. Insurers will usually look to exclude liability to the company which has arisen as a result of dishonest conduct and also losses arising out of a breach where the individual has made a personal profit.

In addition, policies will provide cover subject to a policy “limit of liability”. This is the maximum amount which, once exhausted, means no more will be paid out. The size of a policy’s limit of liability is influenced by various factors. This also raises corporate governance questions, since a higher level of cover could appear to give a licence to those insured to take more risks.

Clearly, the circumstances where a company can indemnify itself now are greatly restricted as a result of sections 232-236 Companies Act. Therefore, Directors and Officers insurance may be the only protection available for directors. However, insurers argue that claims by a company against its own directors are particularly concerning for them. This is because if a company is encountering difficulties a hypothetical situation could arise where the board has the opportunity to launch claims against itself for a potential source of income. Thus, many Directors and Officers policies exclude claims by a company against its directors. As a result, whether a director has cover at all will depend on whether they can bring themselves within an exception to such exclusions.

[59] See *White Paper* at p.23.

4.4 Consequences of liability

4.4.1 Rescission

A transaction made in breach of a director's fiduciary duty is voidable if the company chooses, and it may be rescinded. Rescission involves each party returning to the other what was transferred. A claimant cannot be awarded restitution from the defendant without being able to give counter-restitution to the defendant.[60]

4.4.2 Equitable compensation

The court has indicated in *Extrasure Travel Insurance v Scattergood*[61] that it may award equitable compensation for any loss which is not compensated by the remedies of constructive trust or rescission for breach of fiduciary duty. However, unlike the other remedies this is awarded to make good a loss which can be seen in hindsight to be caused by a breach of a duty. So it will be awarded either if a company has not suffered a loss or if it is probable that the loss would have been suffered even if there had been no breach. *Target Holdings v Redferns*[62] established that the loss must be measured at the time of trial and not the time of the breach of the duty. The test of whether loss caused by a breach of the duty is the "but for" test, whereby compensation is awarded for loss which would have occurred but for the breach.

[60] *Erlanger v New Sombrero Phosphate* [1878] 12 App Cas 1218.
[61] [2003] 1 BCLC 598.
[62] 1996] 1 AC 421.

5 DUTIES IN THE VICINITY OF INSOLVENCY

5.1 Change of existing duties

In general there is not an express duty towards creditors, but section 172(3) makes reference to the common law principle that a director of an insolvent company must have regard to its creditors. This was first formulated in the common law by the Court of Appeal in *West Mercia Safetywear Ltd v Dodd* (1988).[63]

Additionally, in *Colin Gwyer and Associates v London Wharf (limehouse)*[64] it was expressed that there is a duty towards creditors not only where a company is insolvent, but also in a situation of doubtful solvency. The duty arises when a company is on the verge of insolvency and the creditors' money is at risk. In this case, directors are bound when carrying out their duty to the company to consider the interests of the creditors paramount and protect these interests.

Thus, in situations of doubtful solvency or where the company is on the verge of insolvency, directors who deal with company property in a way which is detrimental to creditors will be in breach of a fiduciary duty to the company. However, in practice this will often be very difficult. As Scott VC stated in *Facia Footwear v Hinchcliffe*, "[t]he boundary between an acceptable risk that an entrepreneur may properly take and an unacceptable risk the taking of which constitute misfeasance is not always, perhaps not usually, clear cut…"[65]

5.2 Newly arising duties

The most important codified duty arising in the vicinity of insolvency is the wrongful trading provision, section 214 of the Insolvency Act 1986 (hereafter IA). Under section 214, a court may declare that a director or shadow director knew or ought to have known that a company had no reasonable prospect of not entering insolvency and did not take every step to minimise potential losses to creditors. The duty only arises when no reasonable prospect of avoiding insolvency exists.

The development of the concept of wrongful trading can be traced back to the findings of the Cork Committee Report, which argued that fraudulent trading (which gives rise to liability of directors pursuant to section 213 Insolvency Act) was inadequate to deal with irresponsible trading decisions of directors and there should be a provision whereby directors could be held personally liable. The Committee proposed that there should be civil liability for unreasonable conduct. The government accepted these recommendations and enacted the wrongful trading provisions, which complement but do not replace section 213 Insolvency Act.

[63] BCLC 250.
[64] [2002] EWHC 2748 (Ch) [2003] 2 BCLC 153.
[65] [1998] 1 BCLC 218 at p.228.

In assessing whether a director ought to have known whether insolvency was imminent, the court will apply the standard as set out in section 214(4), which is identical to the duty of care as codified in the Companies Act, section 174. As regards to the limits on liability provided under the Act, to meet the necessary requirements of the defence available under section 214(3), the court will not accept a plea that a director did not appreciate the gravity of the situation and ignorantly disregarded the creditors. However, if a director seeks the advice of an insolvency practitioner and then continues to act in following their advice it is likely that such conduct will fall within the defence.

In relation to ratification by shareholders, it was said in obiter dicta in *Rolled British Steel*[66] that shareholders cannot bind the company to transactions amounting to fraud on creditors. However, the precise extent of the limitation on the power of shareholders to authorise or ratify conduct of a director when a company is insolvent and when there is no fraud has not been developed by the English courts as yet.

As has been mentioned, in addition to the offence of wrongful trading there is also the concept of fraudulent trading. Section 213 of the IA states that:

1. If in the course of the winding-up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.
2. The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper.

As a result of the new liability for wrongful trading introduced by the Insolvency Act under section 214, fraudulent trading is now used relatively rarely since all cases of fraudulent trading by a director which fall within section 213 are likely to fall within the wrongful trading provisions of section 214 and the burden is lower to establish wrongful trading. However, fraudulent trading is still useful as it also applies to conduct by third parties. Sections 213 and 214 have effect even when the person may be criminally liable for the same acts according to section 215(5) of the IA.

In addition, since 1929 successive Acts relating to company law have also contained provisions on fraudulent trading, making it a criminal offence and a ground for imposing personal liability under section 275 of the 1929 Act. The civil sanction may only be invoked in a winding-up, whereas the criminal sanction that is now provided in section 993 of the Companies Act 2006 has applied whether or not the company is or is being wound up. Section 993 states:

1. If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, every person who is knowingly a party to the carrying on of the business in that manner commits an offence.
2. This applies whether or not the company has been, or is in the course of being, wound up.

The section thus creates two offences. First the carrying on of a business with an intent to defraud creditors and secondly, carrying on of a business for any other fraudulent purpose. It is necessary to

[66] Cited above.

show the *mens rea* of acting dishonesty. Fraudulent trading under the Companies Act 2006, which is the most serious offence under the Act, is the only offence with a maximum sentence of more than two years, with a maximum penalty of ten years.

6 ENFORCEMENT OF DUTIES

6.1 Who has standing to sue

6.1.1 The company as plaintiff

The general rule is that the company is the proper plaintiff if the directors have breached a duty owed to the company. The decision whether to enforce a claim of the company against the directors is a management decision. Therefore, the instigation of legal proceedings against the directors falls within the authority of the board of directors.[67] In addition, the decision may be taken by the general meeting, which has the general right to direct the directors to take, or refrain from taking, specified action.[68]

6.1.2 The shareholders as plaintiffs

6.1.2.1 In their own name

The 2006 Act does not affect when an individual can bring a personal action to enforce their individual rights against a company. The Act now provides for a new derivative claim procedure set forth in Chapter 11 of the Act. However, section 260(1) defines derivative claims as proceedings in respect of a cause of action vesting in the company, rather than in a shareholder individually. Thus, the new statutory procedure does not extend to a shareholder enforcing their personal rights.

Equally, the new procedure does not affect rare cases where an individual has a direct claim against either the director personally or against a third party. These claims rarely succeed under the reflective loss principle whereby only the company may sue when it suffers a loss from a breach of duty owed to it, even where the loss results in a decline in the company's share price and the individual seeks to make good that loss.

The interaction between personal claims and derivative claims was discussed extensively by the House of Lords in *Johnson v Gore Wood and Co.*[69] It was held that where the shareholders suffer a loss that is merely reflective of the company's loss such losses cannot be claimed by the shareholders in any action to enforce *the shareholder's* rights. Courts have observed that if the shareholder was allowed to recover such a loss, then there would either be a double recovery at the expense of the defendant or the shareholders will recover at the expense of the company and its other shareholders. This rule is strictly enforced. A small exception remains available where the wrongdoer's own actions have prevented the company from ever being able to enforce the claim.[70] As a result, a personal claim can only be made by a shareholder where they can satisfy two conditions: first that there is a breach of a duty owed to them personally and secondly, that the personal loss is distinct from the loss suffered by the company.

[67] See, for example, Art. 3 *Model Articles for Public Companies*.
[68] Art. 4(1) *Model Articles for Public Companies*.
[69] [2002] 2 AC 1HL.
[70] *Giles v Rhind* [2003] Ch. 618.

6.1.2.2 In the name of the company ('derivative action')

A derivative claim is a claim brought by a shareholder in respect of an action vested in the company where relief is sought not individually but on behalf of the company. Section 260(3) of the Companies Act stipulates that actions can be brought for an actual or proposed act or omission arising from negligence, default, breach of a duty, or breach of trust by a director, which also includes a shadow director. The rationale for this is that the alternative of leaving the decision to the board as to whether to bring an action would be a conflict of interest.

Prior to the statutory regime, the previous common law principles were derived from the rule in *Foss v Harbottle*.[71] That rule established two principles. First, the proper plaintiff principle provided that the company is the only proper claimant in proceedings for a wrong committed to the company. And secondly, the majority rule principle whereby an individual shareholder cannot bring proceedings on behalf of the majority of shareholders if the alleged wrong was committed within the powers of the company, since in those circumstances the majority could lawfully ratify the wrongful transaction. In other words, the minority shareholders could not complain about wrongs that could be cured by a vote in the general meeting.

However, it was eventually recognised that the majority rule principle was not equitable in situations where the wrongdoing directors were part of the majority shareholders, as they could ratify the breach committed by the majority. So exceptions were developed to the *Foss v Harbottle* rule, which allowed, in relation to a limited set of wrongs, a member to bring a derivative action where the wrongdoer controlled the general meeting. In practice, the *Rule in Foss v Harbottle* meant that in widely-held companies derivative litigation was never brought.

The new section 260(1) amends existing case law and makes it the exclusive procedure for bringing derivative claims. In practice, the member enforcing a claim of the company pursuant to sections 260-264 will be a minority shareholder unable to persuade the company to bring proceedings. There is no minimum shareholding stipulated.

In terms of substance, the statutory derivative action mechanism has introduced major changes. Before the introduction of this legislative provision, the approach was restricted to requirements of fraud on the minority and control by the alleged wrongdoers. These requirements no longer appear in the statutory provision. It now extends to any cause of actions within the four types of conduct mentioned by section 260(3) (negligence, default, breach of duty, breach of trust). This is an important point, as previously no action was available where mere negligence by directors had occurred.[72]

The second substantive change in demonstrating a breach of duty is concerned with the fact that there is now no need to prove that the alleged wrongdoers gained some personal benefit. Previously, under the common law, a derivative action could not be brought for a mere breach of fiduciary duty (which is ratifiable) and could only be brought where the directors/majority shareholders were guilty of committing a breach and, in addition, this benefited those shareholders.

[71] (1843) 2 Hare 461.
[72] Pavlides v Jensen [1956] Ch 565.

Procedure for derivative claims

Under the common law, there were strict procedural requirements developed by the courts, which required first *locus standi* to be established. Then the claim on the merits would be heard separately.

The new statutory procedure has been designed to give greater transparency in contrast to the complex procedure which was previously in effect. Section 261 outlines the procedure for applying for permission, which will be granted on the basis of whether various criteria in 263(2) and (3) are met. This is important in terms of certainty as it will aid applicants in their decision about whether to make a court application. They can assess the conduct against the criteria to determine whether their claim is likely to be granted permission to proceed.

A key reason why the courts will not give permission to continue under 263(2) is based on the standard of the objective director in assessing whether the claim is in the best interests of the company. In this regard, the court will consider many factors, including the costs of litigation, the time involved and the impact on the relationship between the shareholders, company, and directors. In addition, courts will consider whether the act was authorised or ratified, or is likely to be authorised or ratified. Even where a claim has not failed under section 263(2) the court still has the discretion to refuse permission under discretionary factors (non-exhaustive) under section 263(3) in considering whether to give permission.

6.2 Criminal and administrative sanctions

In recent years Parliament has significantly extended the circumstances when the courts can declare a person disqualified from being a director. This is done by making disqualification orders or accepting disqualification undertakings under the *Company Directors Disqualification Act 1986.*

One gap in the law relates to a person who becomes personally insolvent and is declared bankrupt. Such a person will automatically commit an offence if he or she acts as a director of a company. In contrast, an individual who directs a company into insolvency is entitled to set up a new company immediately unless and until a court, at its discretion, makes a disqualification order.

7 CONFLICT OF LAWS

7.1 Company law

The treatment of companies under private international law depends on which principle is applied in identifying a company with a particular legal system, based on either the incorporation theory (governed by the law in the country where it was established) or real seat theory (law where company in reality has its centre of management and control).

The UK has preferred the certainty in using a company's place of incorporation as the deciding factor in identifying which law should apply to a company. This approach is reflected in the definition of a company in the Companies Act, which defines a company formed and registered under the Act.

This means that the provisions of the Companies Act 2006 apply only to companies incorporated in England and Wales, whilst foreign companies are regarded as being governed by the laws in their places of incorporation, irrespective of where the company's operations are in reality based. Companies incorporated outside the UK are known as overseas companies and governed by sections 1044-1059 of the Companies Act. This is in contrast to the previous Companies Act 1985, which provided that the Act did not apply at all to companies incorporated outside the UK.

These provisions establish two different regimes. One applies to a company incorporated outside the UK and has a branch in the UK and gives effect to the 11th Company Law Directive (89/666/EEC). The other regime applies to a company not incorporated in the UK that establishes a place of business in the UK but does not fall within the first regime. The 11th Company Law Directive regulates whether a company has a branch in the UK. The other regime applies if the company has a place of business within the UK, which is defined as a permanent location. Companies subject to 11th Company Law Directive must, within one month of opening the branch, deliver to the registrar for registration details of the company branch and the directors' details. Under the other regime, section 691 applies, which also requires the company to submit details regarding the company and records of the directors.

As far as the scope of the English conflict of law rules is concerned, the law at the place of incorporation governs directors' duties. Thus, the duties codified in the CA only apply to a company formed or registered under the Act. The statutory duties do not apply to directors of a foreign incorporated company.

In considering whether equitable duties in the English system would apply to directors of foreign companies, the position is the same. In *Konamaneni v Rolls-Royce Industrial power (India)*[73] it was held that a case concerning the fiduciary duties of the director of a foreign company is governed by the law of the country of incorporation. This is a practical result, as it provides legal certainty in terms of which system of law will govern.

[73] [2002] 1 WLR 1269.

7.2 Tort law

A claim in tort involving an overseas company would be determined by the provisions of the Private International Law (Miscellaneous Provisions) Act 1995. The general rule under section 11(1) of the Act is that the applicable law is the country where the wrong was committed.

However, the general rule can be set aside if in the circumstances it would be substantially more appropriate for the law of the other country to apply according to section 12(1). It is uncertain what approach the courts will take, but given that the general principle of English private international law is that the law of the place of incorporation will govern substantive company law this would indicate that it would be more appropriate for the law of the country of incorporation to apply in relation to tortious liability.

7.3 Jurisdiction

In matters of civil litigation, jurisdiction is governed by the *EC Regulation on Civil Jurisdiction and Judgments (Judgments Regulation).*[74] This stipulates that disputes involving company law should be dealt with in the country where the company has its seat, and the seat for these purposes is determined by the domestic rules of private international law, which in the UK's case, refers to the country of incorporation.

[74] Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.