PAPER OUTLINES*

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Liability of company managers and directors

Pursuant to Article 71, paragraph 1, of the Federal Law "On Joint-Stock Companies" (the Company Law henceforth) members of the Board of Directors (Advisory Board), the sole executive body (CEO, general manager), temporary sole executive body, members of the collective executive body, as well as the managing organization or manager ("company management" henceforth) must act in the best interests of the company and exercise their rights and duties reasonably and in good faith.

Provisions of Article 71, paragraph 1, of the Company Law that prescribe the ways company management must act relate directly with the rule of paragraph 2 of the same article that defines legal effects of any violation by the above parties of their duties. Pursuant to Article 71, paragraph 2, of the Company Law, "members of the board of directors (advisory board), the sole executive body (CEO, general manager), temporary sole executive body, members of the collective executive body, as well as the managing organization or manager, are liable to the company for losses caused to the company by their wrongful action (inaction) unless other reasons or scope of liability are provided for by federal laws."

Several problems arise when courts try to apply the above provisions.

Relations between rules of Article 71 of the Company Law and those of other federal laws that stipulate grounds for and scope of liability of company management.

Pursuant to Article 71, paragraph 2, of the Company Law, "members of the Board of Directors (Advisory Board), the sole executive body (CEO, general manager), temporary sole executive body, members of the collective executive body, as well as the managing organization or manager, *are liable to the company for losses caused to the company by their wrongful action (inaction) unless other reasons or scope of liability are provided for by federal laws*."

Regulating the liability of company management for losses they inflicted on the company, the Company Law establishes the principle of liability for guilt and, effectively, a principle of full compensation of damage. At the same time, however, the Company Law provides that these rules apply unless a federal law provides otherwise. Hence, in all cases when relations between the company management and the company are subject to regulation by other federal laws, and such laws prescribe the scope of and grounds for the liability of managers for damages, it is such law rather than Article 71 of the Company Law that should apply.

At the same time, pursuant to Article 69, paragraph 3, items 2 and 3, of the Company Law, the rights and duties of the sole executive body (CEO, general manager), temporary sole executive body, members of the collective executive body, as well as the managing organization or manager, in the current operations of the company shall be defined by the Company Law, other legal acts of the Russian Federation and the contract executed by the company with each of the above. Additionally, "*relations between the company and the sole executive body (CEO, general manager), and/or members of the collective executive body (Management Board, Directorate) shall be governed by the provisions of labor legislation of the Russian Federation to the extent where they do not contradict with the provisions of this Federal Law*."

The conclusion therefore is that given any conflict between the norms of labor legislation and the Company Law whenever they apply to the relations between the company and the CEO and the management board, rules of the Company Law shall prevail.

However, the RF Labor Code provides that labor norms contained in other laws should be consistent with the Code's provisions (Article 5, paragraph 8).

In its award of 24 June 2003, No A56-1576/03, the Federal Commercial Court of the Northwestern District found that the shareholder was suing an individual, the CEO of the company, for damages incurred to the company when the CEO was in office. The cassation instance noted that "Article 71 of the Federal Law "On Joint-Stock Companies" sets the procedures for invoking liability for damages for the chief

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executive manager of the company as its sole executive body. However, the basic grounds for such liabilities are stipulated by the labor legislation. Pursuant to Article 277 of the Labor Code of the Russian Federation, the manager of the organization bears full liability for direct actual damages inflicted on such organization. In cases stipulated by the federal law the manager of the organization shall compensate the organization damages incurred through his guilty actions. In accordance with the terms and conditions of the labor contract between the company and its general manager, the respondent shall be liable for damages inflicted on the company pursuant to the effective legislation. "Hence, was the conclusion of the cassation instance, the company's general manager shall be liable to the company for damages created to the company through guilty actions of the CEO, subject to Article 277 of the Labor Code of the Russian Federation and in the manner prescribed by Article 71 of the Federal Law "On Joint-Stock Companies."

As for other company management members (members of the Board of Directors, managing organization or manager), by virtue of Article 71, paragraph 2, of the Company Law the grounds for and scope of their liability for damages shall be stipulated by the Company Law itself, *unless federal laws prescribe other grounds for or scope of liability*.

Defining the nature of relations connecting company management and the company, as well as the nature of obligations.

Admittedly, the legal status of company management is variable and subject to regulation by a variety of norms. Therefore, norms regulating their liability to the company would apply differently to different parties:

1) a party performing the functions of a sole executive body of the company is liable to the company under the applicable rules of both company and labor legislation as long as this person is party to labor relations with the company, as well as under norms of civil legislation.

2) the managing organization or manager, performing the functions of the sole executive body on the basis of a civil law business contract between such manager and the company shall be liable to the company under company law rules and norms of civil legislation that govern contractual liability.

3) the liability of a board member to the company is extra-contractual, although, according to B.R. Korabelnikov, "there are no reasons to discuss tortious relations here." Therefore, liabilities of these persons to the company shall be defined by the rules of the company law and civil legislation while contract liability norms will not apply. These are either norms governing liabilities for damage or, if we are to agree with Korabelnikov, the rule of Article 15 of the Russian Civil Code.

4) members of the collective executive board (Management Board) are party to labor relations with the company and their liability therefore shall be regulated by the norms of the same branches of law that apply to the liability of a person performing functions of a sole executive.

The issue of the grounds for and scope of liability follows from the choice of legislative norms that are supposed to govern liability of the specific company manager to the company, and the terms and conditions of the contract, should the liability of the manager be arising from any such contract.

We may conclude then that there is no one single regime that the legislation applies to the liability of company management to the company.

Additionally, the regulation of company management's liability is further confused by Article 71, paragraph 3, of the Company Law, which states that *for purposes of defining grounds for and scope of liability* of members of the Board of Directors (Advisory Board), the sole executive body (CEO, general manager), and/or members of the collective executive body (Management Board, Directorate), as well as the managing organization or manager, ***one must consider common business practices*** *and other circumstances* material for the case. Since Article 71, paragraph 2, of the Company Law explicitly states the principle of company management's liability for damages to the company and the principle of full compensation of damages, it is rather difficult to explain what are these common business practices defining the grounds for and scope of liability of the company management that should be considered by court when examining relevant liability disputes.

Defining jurisdiction of courts of law and commercial courts in the claims of damages inflicted to the company by its management.

Currently claims of damages inflicted to the company by its management are referred to the jurisdiction of both commercial courts and court of law.

The Reviews of legislation and judiciary practices by the Supreme Court of the Russian Federation in Quarter III of 2003, approved by the Presidium of the Supreme Court of 3 and 24 December 2003, offered the following answer to a question about the applicable jurisdiction in case of disputes between the

company and its former CEO about claims of damages to the company arising from the CEO actions while in office:

"Under the general jurisdiction rule the criteria for the delimitation of competence should be served by the nature of parties and disputes.

Commercial courts have jurisdiction over economic disputes and other claims relating to entrepreneurial or other business activities provided the parties are legal entities or self-employed entrepreneurs (Article 27 of the Arbitration Procedures Code (APC) of the Russian Federation).

Rules of special jurisdiction in Article 33 of the APC refer some other claims to the jurisdiction of commercial courts.

In the case at hand, one of the parties of the action is an individual, the former CEO of the company.

Under the general jurisdiction rule, the dispute may not be referred to the commercial court as it does not meet the parties in action criterion: it involves an individual who is not a self-employed entrepreneur.

Under the special jurisdiction rules, this dispute may not be referred to the commercial court also because provisions of Article 33 of the APC (paragraph 4, item 1) on special jurisdiction relate to disputes between the shareholder and the company, except labor disputes.

Relations between the CEO and the company arise from the labor contract (Chapter 43 of the Labor Code of the Russian Federation). Hence, claims of damages by the company to its CEO (including a former CEO) that incurred the company these damages while in office, arise from labor relations and as a labor dispute case should be referred to the court of law."

As a result, according to the Supreme Court of the Russian Federation, whoever the claimant suing the CEO, the shareholder or the company, such disputes should be referred to the courts of law.

The Federal Commercial Court of the Northwestern District in its award of 24 June 2003, No A56-1576/03, also concludes that the action of the shareholder against an individual, the company's CEO, claiming damages incurred by the company, "stems from labor law relations arising between the company and its executive body. Performance of any labor duties subject to the labor contract by the respondent who is an individual does not qualify as entrepreneurial activity." While pursuant to Article 33, paragraph 4, item 1, of the APC, disputes arising from labor law relations cannot be referred to commercial courts.

However, in another dispute, the Federal Commercial Court of the Moscow District (resolution of 20 July 2004, No КГ-А40/6009-04) found that the shareholder sued the company's CEO claiming damages incurred through his wrongful actions pursuant to Article 71 of the Company Law, and concluded as follows: "This dispute is not a labor dispute because subject to Article 33, paragraph 3, item 1, of the APC, Article 71, paragraph 5, of the Company Law, and explanations presented in paragraph 37 of the Resolution of the Plenary Session of the Higher Commercial Court of the Russian Federation of 18 November 2003, No 19, this dispute should be referred to the commercial court."[1].

Significantly, the Federal Commercial Court of the Moscow District substantiated its conclusion invoking paragraph 37 of the Resolution of the Plenary Meeting of the Higher Commercial Court of the Russian Federation of 18 November 2003, No 19 "On some issues of application of the Federal Law 'On Joint-Stock Companies'.

In the above paragraph, in conjunction with paragraph 38, the Plenary Session of the Higher Commercial Court explained to courts that "claims lodged by shareholders (including shareholders who are physical persons) in the cases cited in this Resolution (including claims of shareholders to any member of the Board of Directors (Advisory Board), a sole executive body (CEO, general manager), any member of a collective executive body (Management Body, Directorate), as well as to the management organization or manager, seeking compensation of damages incurred by the company through their wrongful action (inaction), should be referred to commercial courts in accordance with the APC of the Russian Federation."

In offering this explanation to courts, the Plenary Session of the Higher Commercial Court of the Russian Federation effectively admitted that such cases arising from shareholders' claims to persons listed in Article 71, paragraph 5, of the Company Law were the jurisdiction of commercial courts.

However, neither the applicable Arbitration Procedures Code of the Russian Federation, nor Resolutions of the Plenary sessions of the Higher Commercial Court of the Russian Federation of 9

[1] The same view was assumed by the Federal Commercial Court of the Northern Caucasus District (award of 27 May 2003, No Ф08-1555/2003), Federal Commercial Court of the Central District (award of 13 February 2004, No A08-5583/03-4)

December 2002, No 11, or of 18 November 2003, No 19, offer a definitive answer to a question of commercial courts jurisdiction over claims of the company itself to its management. Only in one specific case where the powers of the sole executive body in the company have been delegated to a commercial entity (a management company), or self-employed entrepreneur (manager) (Article 69, paragraph 1, item 3, of the Company Law) there are no doubts in the jurisdiction of commercial courts over company claims to such person by virtue of Article 28 of APC.

Proving the guilt of the company manager (director) and damages to the company.

According to Article 15 of the Civil Code of the Russian Federation, damages are any expenses that the person whose rights have been violated has incurred or will have incurred to remedy the right violated (real damage), as well as the missing income that such person would have received in ordinary business practice if his right had not been violated (lost opportunity). Effectively, to seek damages inflicted by the company manager to the company, it is important, apart from judging on the size of damages, to establish the fact of violated obligations and the cause and effect relations between the abuses and ensuing losses.

Since both Article 71 of the Company Law and Article 277 of the Labor Code of the Russian Federation, as well as Article 401 of the Civil Code, stipulate liability for guilt, it is necessary to establish the guilt of the company manager, which is one of the most difficult problems in litigation.

The simplest case is when the court of law issues a judgment convicting the company manager of a crime described in one of the following articles of the Criminal Code of the Russian Federation:

- Article 201 – the person who performs managerial functions in a commercial organization, uses his powers contrary to the legitimate interests of such organization and for purposes of extracting benefits and privileges for himself or other persons, provided such actions have resulted in significant injury to rights and legitimate interests of the organization;
- Article 196 – premeditated bankruptcy, i.e., intentional institution or enlargement of insolvency induced by the manager or owner of a commercial organization, or else a self-employed entrepreneur for personal benefits or in the interests of other persons;
- Article 199 – tax evasion by an organization as a result of non-submission of a tax declaration or other documents, the submission of which is mandatory pursuant to the Russian tax legislation; or else by inclusion in the tax declaration or any other such documents of knowingly fictitious data.

The guilt of the company management can be established also by court when it examines claims of damages by the company. For instance, in its award of 27 May 2003, No Ф08-1555/2003, the Federal Commercial Court of the Northern Caucasus District found that having entered in a contract with a contractor and having failed to make any steps to disallow payments to such contractor that had not performed his obligations, the general manager violated the requirements to act reasonably and in good faith as provided for by Article 53 of the Civil Code. "Such actions were the reason for the company to incur losses in the amount of all payments that were made to and remained non-repaid by the contractor."

Claims seeking to invalidate transactions or acts made by the company management, as an alternative to claims of damages to the company.

It appears to follow from commercial courts practices that a lot of cases in the overall litigation practices relating to the abuses by company managers against company interests are not damages claims but rather claims to invalidate transactions or acts made by them.[2]

The appellate instance of the Commercial Court of the city of Moscow, in its resolution of 11 April 2001, No A40-1362/01-113-19, proceeding from the award of the Tagansky intermunicipal court of Moscow of 16 March 2000, invalidated the power of attorney for civil law transactions issued to a citizen by the general manager on behalf of the company, with the power of substitution, reasoning that having issued such power of attorney, the general manager was acting in bad faith and against the interests of the company. The court offered the following reasoning:

"Pursuant to Article 53 of the Civil Code, a legal entity acquires civil rights and assumes civil obligations vested in its bodies that act in compliance with the law, other legal acts and articles of incorporation. Paragraph three of this article stipulates that the person, who acts on behalf of the company by virtue of law or articles of incorporation, must act in the interests of the legal entity he represents, in good faith and reasonably. Since by issuing the disputed power of attorney the executive body in the person of the general manager failed to act in good faith and prejudiced the interests of such legal entity, as

[2] See, e.g., the award of the Federal Commercial Court of the Northern Caucasus District of 9 April 2003, No Ф08-1053/2003, or the award of the Federal Commercial Court of the Urals District of 23 June 2000, No Ф09-548/2000-ГК

proved by the effective award made by the Tagansky intermunicipal court of Moscow, dt. 16 March 2000, the respondent in the person of the sole executive body of the company, i.e. its general manager, was acting in violation of Article 53 of the Civil Code. Pursuant to Article 168 of the Civil Code, such transaction shall be deemed null and void and, pursuant to Article 167, paragraph 1, of the Civil Code, shall have no legal effects as of the time it was made."

The literature offers also some reasoning of the court's invalidation of a transaction made by the company management against company interests where such transactions are treated as abuse of power in violation of the company's charter (Article 174 of the Civil Code)[3].

However, violations per se of the company interests by its management in civil law transactions, in decisions, acts or documents, shall not serve grounds for deeming them invalid, illegal, etc. That was the position reflected in the ruling of the International Commercial Court of Arbitration of the Chamber Of Industry and Commerce of the Russian Federation, dt. 11.06.2002 on cases Nos 125/2000, 126/2000 and 143/2000. "The violations per se of the plaintiff's interests allowed by the managing organization may not serve grounds for recognizing the Arbitration agreement between the plaintiff and the respondent invalid. In accordance with the agreement between the plaintiff and the managing organization, such violations give the plaintiff the right to claim damages from the managing company."[4]

Presenting claims seeking to invalidate transactions made by the company management against company interests and relying on the effects of invalidation of such transactions seem to be possible, after all, but only provided such claims rest on grounds stipulated by law, e.g., Articles 170, 173, 174, and 179 of the Civil Code.

[3] Sklovsky K. On the effects of transactions by the company manager against interests of the organization. // Business and Law, No 5, 1998.

[4] Practices of the International Commercial Court of Arbitration of the Russian Chamber of Industry and Commerce in 2001-2002, *M. Statut*, 2004