

INFORMATION LETTER

MANAGEMENT LIABILITY: POTENTIAL RISK ZONES

The recent court practice shows that lawsuits seeking compensation of damages caused to company by its management are being filed with increasing frequency. It is largely due to courts' departure from formalistic approach to the assessment of actions carried out by the management of a legal entity.

It is important to note that an obligation to act in good faith and reasonably covers not only the general director as such, but also other management bodies, including members of the board and so called *shadow directors*, that is those who formally do not hold any office in a company, however in fact manage it.

In this bulletin we focused on the most important issues of management liability in light of the recent court practice.

POTENTIAL RISK ZONES FOR THE COMPANY MANAGEMENT

If we factor out such breaches of management liabilities that can potentially be subject to criminal prosecution, and cases when assets were evidently siphoned off in bad faith, we can single out the following company activities which should be considered carefully in a context of adverse consequences for the management.

Change in company ownership

The recent court practice supports the position that a new owner (member, shareholder) has a right to file a lawsuit seeking compensation of losses caused to the company by the director even though he acquired the company after the losses had been caused.¹ In situation transaction documents do not sufficiently protect the new owner (for example, in case the requisite terms were not included, a mistake was made while the documents were drafted, *etc*), an opportunity to recover losses caused to the company by its director before, can become a very attractive option for the new owner.

Intragroup transactions

As a matter of practice, some companies often need to enter into transactions that are potentially loss-making for that

very company, but are in the interests of the group as a whole (for example, accumulation of cash flow within one company, an intragroup transfer of property, *etc*). Such transactions are potentially risky from the perspective of liability of the subsidiaries' management.

Special attention shall be drawn to the situations when there are minority shareholders in such subsidiaries which may file lawsuits against the management, and when a sale of such a subsidiary is planned in the nearest future.

Even approval of such transactions by the parent company (for instance, as a related-party transaction) will not discharge the management from the liability for breach of obligation to act in the interests of the company such management controls.²

Subsidiaries activities

Another novel idea found in court practice is the idea that the management of the parent company shall not opt out of control over its subsidiaries activities.³ Of course, this does not mean that the parent company management is fully liable for any actions made by the subsidiaries directors, however, under certain circumstances, the parent company management may be held liable for subsidiaries directors' actions and transactions.

Public liability

Although this matter used to be contestable in practice the recent tendency is actual shifting of responsibility for breach of public liabilities (tax, administrative, customs, antimonopoly, *etc*) to the director.⁴ In some cases the scope of penalties provided by respective legislation can be rather significant. That said court practice concedes that ambiguity of law (if such ambiguity is found and properly proved) can serve as a ground for releasing the management from liability for bringing the company to public liability.

Selling assets at a discount and selling assets

Selling company assets at a significant discount as compared to an arm's length price, as well as selling loss-making assets for a token fee, can potentially be qualified

¹ Clause 10 of Ruling of the Plenum of the Higher Arbitrazh Court of the Russian Federation No. 62 *On some issues related to compensation of losses by individuals being members of the management of body of the legal entity* dated 30 July 2013.

² Clause 7 of Ruling of the Plenum of the Higher Arbitrazh Court of the Russian Federation No. 62 *On some issues related to compensation of losses by individuals being members of the management of body of the legal entity* dated 30 July 2013.

³ See, for example, Ruling of the Presidium of the Higher Arbitrazh Court of the Russian Federation No. 12505/11 dated 6 March 2012 with respect to proceedings No. A56-1486/2010.

⁴ Clause 4 of Ruling of the Plenum of the Higher Arbitrazh Court of the Russian Federation No. 62 *On some issues related to compensation of losses by individuals being members of the management of body of the legal entity* dated 30 July 2013.

as unreasonable actions of the management. The practice however provides for an exemption from liability if it is proved that a transaction unprofitable for the company was entered into in order to prevent yet greater damage to latter's. No liability arises also if it is proved that the transaction made, although unprofitable itself, was a part of series related transactions which are expected to be profitable in aggregate.⁵

Delegating authority

In major companies many powers to enter into transactions, manage some subdivisions of the company are often delegated to respective executive officers (heads of departments, legal services, financial directors, etc). The absence of proper delegation procedure and negligent recruitment, issuing powers of attorney granting too broad powers, lack of control over employees' performance of their obligations may entail the situation when the directors become responsible for losses caused to the company by their employees.⁶

Redundancy and unreasonable employees compensation

The recent court practice confirms that those losses that were incurred by the company due to unlawful dismissal of its employees can be recovered from the director.⁷ This factor is of particular significance in case of dismissal of highly-paid specialists and layoffs in the company. In case of a failure to observe labour law requirements the amount of potential damage incurred by the company can be significant.

Unreasonably high compensations (including golden parachute agreements) payable to employees in the event of poor performance of the company is also in risk zone.⁸

Competing business

It is not uncommon when the top management initiates its own business which may potentially compete with the business of the company where they hold a top managerial position. It is also not uncommon when one top manager holds office in management bodies of different companies which may compete in some spheres. Potentially actions of the directors in the situation of a conflict of interests may entail recovery of losses from the director in favour of the company which interests were infringed.⁹ That is why the issues related to managing by directors a compete business require careful attention and analysis in view of possibility for the directors to breach their obligations to act loyally.

RISK MANAGEMENT

Among the principal tools permitting to curtail the management's risks of being held liable are:

- *Liability limitation agreement.* The recent changes to the Civil Code of the Russian Federation permit conclusion of an agreement limiting or excluding liability of non-public companies' management for its unreasonable actions. This option is not available for public companies. We note that liability for actions in bad faith may not be excluded or limited by contract.
- *Internal policies.* Establishing a system of internal procedures in the company providing for control over the management process may minimize the liability.
- *Engaging competent advisers in case the company management lacks necessary experience.* The director acts reasonably when, in particular, he collects maximum available information about contemplated action or transaction and engages competent advisers in case the manager and his team lack special knowledge and experience.
- *Liability insurance (D&O).* This insurance product is becoming more and more popular nowadays, and increasing number of insurance agencies offer it to their clients. Certainly, while entering into an insurance agreement one should pay attention to the list of insured events and exceptions.

December 2014

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⁵ Clause 2 of Ruling of the Plenum of the Higher Arbitrazh Court of the Russian Federation No. 62 *On some issues related to compensation of losses by individuals being members of the management of body of the legal entity* dated 30 July 2013.

⁶ Ruling of the Higher Arbitrazh Court of the Russian Federation No. 9324/13 dated 21 January 2014 with respect to case No. A12-13018/201; Clause 5 of Ruling of the Plenum of the Higher Arbitrazh Court of the Russian Federation No. 62 *On some issues related to compensation of losses by individuals being members of the management of body of the legal entity* dated 30 July 2013.

⁷ For example, Ruling of the Federal Arbitrazh Court for the North-Western District No. A56-48229/2013 dated 11 June 2014.

⁸ Ruling of the Higher Arbitrazh Court of the Russian Federation No. A40-104578/12-22-1017 dated 16 October 2013.

⁹ See, for example, Ruling of the Higher Arbitrazh Court of the Russian Federation dated 6 March 2014 with respect to case No. A55-6679/2013; Clause 2 of Ruling of the Plenum of the Higher Arbitrazh Court of the Russian Federation No. 62 *On some issues related to compensation of losses by individuals being members of the management of body of the legal entity* dated 30 July 2013.

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