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A Worldwide Review
Third Edition

Edited by
Alexander Loos



the global voice of
the legal profession®

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International Bar Association

The Global Voice of the Legal Profession



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The International Bar Association (IBA), established in 1947, is the world's leading organisation of international legal practitioners, bar associations and law societies. The IBA influences the development of international law reform and shapes the future of the legal profession throughout the world.

It has a membership of over 55,000 individual lawyers and 206 bar associations and law societies spanning all continents. It has considerable expertise in providing assistance to the global legal community as well as being a source of distinguished legal commentators for international news outlets.

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Contributors

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Contributors

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Contributors

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Summary of Contents

Editor	vii
Contributors	ix
Preface	lxix
List of Abbreviations	lxxi
Argentina <i>Javier M. Petrantonio & Laura Lavia Haidempergher</i>	1
Australia <i>Rory Moriarty</i>	15
Austria <i>Christian Dorda</i>	27
Belarus <i>Dmitry Viltovsky</i>	39
Belgium <i>Philippe Malherbe</i>	51
Bermuda <i>David William Peter Cooke</i>	63
Bolivia <i>Ignacio M. Aguirre U.</i>	73
Brazil <i>Walter Douglas Stuber</i>	85

Summary of Contents

Canada <i>Markus Koehnen & Stephen Brown-Okruhlik</i>	97
Cayman Islands <i>Antony G.D. Duckworth, Alan G. de Saram & Wendy Stenning</i>	109
Chile <i>Pablo Guerrero V.</i>	117
Czech Republic <i>Dagmar Dubecká</i>	127
Denmark <i>Niels Bang</i>	137
Ecuador <i>Javier Robalino-Orellana, Daniel Robalino Orellana, Martín Pallares Sevilla & Estefanía Alarcón</i>	147
Estonia <i>Sven Papp & Kaspar Kolk</i>	157
The European Action Plans of 2003 and 2012 <i>Thorsten M. Volz</i>	169
Finland <i>Riikka Rannikko & Jesse Collin</i>	179
France <i>Jacques Buhart & Nicolas Lafont</i>	189
Germany <i>Alexander Loos</i>	203
Hong Kong <i>Allan Leung & Danny Leung</i>	213
India <i>Som Mandal</i>	227
Indonesia <i>Lia Alizia & Valdano Ruru</i>	239
Ireland <i>Stephen Hegarty & Maeve Moran</i>	251
Israel <i>Ehud Sol & Haim Machluf</i>	263

Summary of Contents

Italy <i>Gabriele Fagnano</i>	275
Japan <i>Norio Mitsuuchi</i>	287
Latvia <i>Jānis Gavars, Reinis Sokolovs & Raimonds Slaidiņš</i>	297
Luxembourg <i>Alexander Koch</i>	309
Mexico <i>Daniel Del Rio & Juan José López-de-Silanes</i>	323
Mongolia <i>Chris Melville, Anthony Woolley & Ariungoo Khurelbaatar</i>	335
The Netherlands <i>Willem Calkoen & Martin Grablowitz</i>	345
New Zealand <i>Pip England</i>	355
Nigeria <i>Ayodeji Oyetunde & Lotanna Nwodo</i>	369
The People's Republic of China <i>Liang Xu & Sarah Zhang</i>	379
Poland <i>Tomasz Żak</i>	391
Portugal <i>Miguel de Avillez Pereira & Hugo Teixeira</i>	401
The Russian Federation <i>Doran Doeh & Svetlana Barinova</i>	411
Singapore <i>Stephanie Keen & Matthew Bousfield</i>	421
South Africa <i>Nastascha Harduth, Eric Levenstein, David Gewer & Derek Alexander</i>	433
South Korea <i>Kyung-Taek Jung & Hye-Sung Kim</i>	445
Spain <i>Enric Picanyol & Coro Fernández-Rañada</i>	457

Summary of Contents

Sweden <i>Björn Kristiansson & Per Samuelsson</i>	469
Switzerland <i>Matthew T. Reiter & Lorenz Naef</i>	479
Turkey <i>Serdar Paksoy & assisted by Deniz Özkan</i>	493
Ukraine <i>Timur Bondaryev, Pavlo Khodakovsky & Alesya Pavlynska</i>	505
United Arab Emirates <i>Imtiaz Shah</i>	517
United Kingdom <i>Karla Dudek</i>	529
United States of America <i>Robert Ripin</i>	541
Vietnam <i>Jeff Olson & Minh Nguyen</i>	553
Index	565

Table of Contents

Editor	vii
Contributors	ix
Preface	lxix
List of Abbreviations	lxxi
Argentina	
<i>Javier M. Petrantonio & Laura Lavia Haidempergher</i>	1
I 'National Basics' and National Legal Theories of Directors' Liabilities	1
[A] Corporations Legal System in Argentina	1
[B] Board's Authority and Structure	2
[1] Rules - Meetings	2
[2] Duties of the Board	2
[3] Composition of the Board	3
[4] Directors' Compensation	3
[C] Directors' Appointment and Conditions	4
[1] Election of Directors	4
[2] Individuals Precluded to Be Appointed as Directors	5
[D] Delegation	5
[E] Removal of Directors	6
II Recent Cases Dealing with Directors' Liabilities	6
[A] Nature of Directorss' Liabilit	6
[B] Directorsshe been Aware of Said Misconducts	6
[C] Cases Related to the Administration of the Company	7
[D] Delegation and Activities in Competition with the Company	7
III Judicial Review (Tightening of Standards?)	7

Table of Contents

	[A] Tightening of Standards?) Interests If They Engaged in a Business	7
	[B] Standard of Diligence	8
	[C] Damages to the Company and Liability: General Conditions	10
	[D] Judicial Procedure	10
IV	Corporate Governance	10
V	Liability Issues	11
	[A] The Responsibility Actions Ruled by the Companies Act	11
	[1] Corporate Liability Action Filed by the Company ('Acción de Responsabilidad Social')	11
	[2] Corporate Liability Action Filed by Any Shareholder	12
	[3] Individual Responsibility Action	12
	[B] Limits (Caps)	13
	[C] Directors' Joint Liability	13
VI	Indemnification	13
VII	Lawyer Directorship	13
Australia		
	<i>Rory Moriarty</i>	15
I	Introduction	15
II	'National Basics' and National Legal Theories of Directors' Liabilities	15
	[A] Two-Tiered or Unitary Company Structure	15
	[B] Chairman and CEO (One or Two People/Checks and Balances)	15
	[C] Board Structures	16
	[D] Elections/Staggering	16
	[E] Delegation	16
	[F] Removal of Directors	17
III	Recent Cases Dealing with Directors' Liability	17
IV	Judicial Review (Tightening of Standards?)	18
V	'Socio-Anthropological Issues'	18
	[A] Is Board Composition Changing in Australia in Light of Recent Developments?	18
	[B] Are the Decision-Making Mechanisms Changing in Australia in Light of Recent Developments?	18
	[C] Board/Management Relationship	19
VI	Corporate Governance	19
	[A] Board Procedures	19
	[B] Structures of Oversight (Mechanisms, Etc.)	20
VII	Liability Issues	20
	[A] Who Can Sue?	20
	[1] The Company and Individual Shareholders	20
	[2] Australian Securities and Investments Commission	21
	[3] Creditors	21
	[B] Who Can Be Sued?	21

Table of Contents

	[C] On What Basis Can a Director Be Sued?	22
	[D] Thresholds and Limitations/Caps of Liabilities in Australia (Statutory Limitations on Directors' Liability)	22
	[1] Duty of Care and Diligence	22
	[2] Duty to Prevent Insolvent Trading	23
	[E] Joint Liability/Solidarity	23
	[F] Derivative Actions	23
	[G] Class Actions	24
	[H] Bankruptcy and a Directors' Liability Suit	24
	[I] Costs and Fees in Liability Litigation	25
VIII	Indemnification	25
IX	Directors' and Officers' Insurance	25
X	Other Methods of Protection	26
XI	Lawyer Directorship	26
	Austria	
	<i>Christian Dorda</i>	27
I	'National Basics' and National Legal Theories of Directors' Liabilities	27
	[A] Composition and Structure of Boards	27
	[B] Appointment, Election, Delegation and Removal of Directors	28
	[C] General Principles of Directors' Liability	28
	[1] Liability of Directors towards the Company	29
	[2] Liability of Directors towards Third Parties	29
II	Recent Cases Dealing with Directors' Liability	30
III	Judicial Review: Tightening of Standards?	31
IV	Typical Schemes to Avoid Director's Liability	32
	[A] Changing Composition of Boards	32
	[B] Changing Decision-Making Mechanism	32
	[C] Relationship Board/Management	32
V	Corporate Governance	33
VI	Liability Issues	34
	[A] Who Can Sue?	34
	[1] The Company	34
	[2] Shareholders	34
	[3] Third Parties	34
	[B] Who Can Be Sued?	35
	[1] Directors	35
	[2] The Company	35
	[C] Thresholds and Limitations	35
	[D] Joint Liability/Solidarity	35
	[E] Derivative Actions	35
	[F] Class Actions	36
	[G] Relevance of Bankruptcy	36
	[H] Costs and Fees in Liability Litigations	36

Table of Contents

VII	Indemnification	36
VIII	Directors' and Officers' Insurance	36
IX	Other Methods of Protection	37
X	Lawyer Directorship	37
Belarus		
	<i>Dmitry Viltovsky</i>	39
I	National Legal Framework and Theoretic Aspects of Directors' Liability	40
	[A] One-Level or Two-Level Company Structure	40
	[B] Chairman of the Board of Directors/Director	40
	[C] Collective Executive Body	41
	[D] Appointment/Election of Directors	41
	[E] Requirements for Appointment of the Director	42
	[F] Delegation of the Director's Powers	42
	[G] Termination of the Director's Activity	42
II	Case Law on the Directors' Liability	42
III	Estimation of the Legal Regulation of the Directors' Liability	43
	[A] Liability before the Shareholders (Owners) of the Company	43
	[B] Disciplinary Responsibility	43
	[C] Liability for Damages	44
	[D] Administrative Responsibility	44
	[E] Criminal Responsibility	45
IV	Standard Behavior Models to Avoid the Directors' Liability	45
V	Corporate Governance	45
VI	Liability Issues	46
	[A] Who Can Be a Plaintiff?	46
	[1] Company	46
	[2] Shareholders	46
	[3] Crisis Manager	47
	[4] Creditors and Third Parties	47
	[5] Government	47
	[B] Who Can Be a Defendant?	47
	[C] Factual Director	48
	[D] Limitation and Excess of Liability	48
	[E] Joint and Several Liability	48
	[F] Derivative Suits	48
	[G] Collective/Class Action Suits	48
	[H] Suits Against the Director within the Bankruptcy	49
VII	Compensation of Damages by the Company That Are Inflicted by the Director to a Third Person	49
VIII	Director's Insurance	49
IX	A Lawyer as the Director	49
X	Predictions on Future Legislation Development	49

Belgium		
	<i>Philippe Malherbe</i>	51
I	National Basics and National Legal Theories of Directors' Liability	51
	[A] Two-Tiered or Unitary Company Structure	51
	[B] Chairperson/CEO	52
	[C] Board Structures	52
	[D] Directors' Elections	53
	[E] Directors' Term of Appointment	53
	[F] Delegation	53
	[G] Removal of Directors	54
	[H] Representation of the Company	54
II	Liability Issues	54
	[A] Who Can Be Sued?	54
	[1] Permanent Representatives	55
	[2] Managing Director or Delegate to Daily Management	55
	[3] De Facto Director	55
	[B] Who Can Sue?	55
	[C] Liability Grounds	56
	[1] Criminal Liability	56
	[2] Civil Liability	56
	[a] Contractual Liability	56
	[b] Tort Liability	57
	[c] Bankruptcy Related Liability	57
III	Corporate Governance	58
IV	Recent Cases	58
	[A] Grounds of Liability	59
	[B] Directors' Liability for Tax Debts	59
	[C] Sellers' Liability as Former Directors of the Target	60
	[D] Information Duties	60
	[E] False or Inexact Balance Sheet	60
V	Judicial Review	60
VI	Directors' Liability Insurance	61
VII	Indemnification	61
VIII	Other Methods of Protection	61
	[A] Reporting Faults	61
	[B] Exonerated Clauses	62
IX	Lawyer Directorship	62
Bermuda		
	<i>David William Peter Cooke</i>	63
I	'National Basics' and National Legal Theories of Directors' Liabilities	63
	[A] Role of Chairman and CEO	63
	[B] Board Structures	64

Table of Contents

[C]	Directors' Election	64
[D]	Delegation	65
[E]	Removal of Directors	65
II	Recent Cases Dealing with Directors' Liability	65
III	Judicial Review	65
IV	Typical Approach to Avoid Directors' Liability	66
[A]	Composition of the Board	66
[1]	Are the Decision-Making Mechanisms Changing?	66
[2]	Board/Management Relationship	66
V	Corporate Governance	66
VI	Liability Issues	67
[A]	Who Can Sue?	67
[B]	Who Could Be Sued?	68
[C]	'De Facto' Directors	68
[D]	Thresholds and Caps on Liability	68
[E]	Joint Liability/Solidarity	69
[F]	Derivative Actions	69
[1]	Class Actions	69
[2]	Relevance of Bankruptcy of Company with Regard to Bringing a Directors' Liability Suit	69
[3]	Costs and Fees in Liability Litigation	70
VII	Indemnification	70
VIII	Directors' and Officers' Insurance	70
IX	Other Methods of Protection	70
X	Lawyer Directorships	70
XI	Forecast on Future Legislation Development	71
Bolivia		
	<i>Ignacio M. Aguirre U.</i>	73
I	National Basics and National Legal Theories of Directors' Liabilities	73
[A]	Introductory Aspects: Corporate Governance Issues	73
[B]	Board of Directors	75
II	Board Members' Liabilities	80
[A]	General Issues	80
[B]	Indemnifications of Directors and Liability Insurance	82
[C]	Recent Cases Dealing with Directors' Liability	83
[D]	Typical Schemes/Behaviour to Avoid Directors' Liability	83
[E]	Forecast on Future Legislation Development	83
Brazil		
	<i>Walter Douglas Stuber</i>	85
I	"National Basics" and National Legal Theories of Directors' Liabilities	85
[A]	Overview	85

Table of Contents

	[B] Limitada	85
	[C] <i>Sociedade Por Ações</i> (“SA”)	87
II	Recent Cases Dealing with Directors’ Liability	89
III	Judicial Review (Tightening of Standards)	89
IV	Typical Schemes/Behavior to Avoid Directors’ Liability	89
V	Corporate Governance	90
VI	Liability Issues	92
	[A] Who Can Sue?	92
	[B] Who Can Be Sued?	92
	[C] “De Facto” Director	93
	[D] Thresholds and Limitations/Caps of Liabilities	93
	[E] Joint Liability/Solidarity	93
	[F] Derivative Actions	94
	[G] Class Actions	94
	[H] Relevance of Bankruptcy of Corporation	94
VII	Indemnification	95
VIII	Directors’ and Officers’ Insurance	95
IX	Other Methods of Protection	95
X	Lawyer Directorship	96
XI	Forecast on Future Legislation Development	96
Canada		
	<i>Markus Koehnen & Stephen Brown-Okruhlik</i>	97
I	‘National Basics’ and National Legal Theories of Directors’ Liabilities	97
	[A] Two-Tier or Unitary Company Structure	97
	[B] Chairman/CEO	97
	[C] Board Structures	98
	[D] Elections/Staggering	98
	[E] Delegation	98
	[F] Removal of Directors	99
II	Recent Cases Dealing with Directors’ Liability	99
III	Judicial Review (Tightening of Standards?)	101
	[A] Judicial Deference to Directors’ Business Decisions	101
	[B] Are Decision-Making Mechanisms Changing in Light of Recent Developments?	102
	[C] Relationship between Board and Management	103
IV	Corporate Governance	103
	[A] Board Procedures	103
	[B] Structures of Oversight	104
V	Liability Issues	104
	[A] Who Can Sue?	104
	[B] Who Can Be Sued?	105
	[C] De Facto Directors	105
	[D] Thresholds and Limitations/Caps of Liabilities	105

Table of Contents

[E]	Joint Liability	106
[F]	Derivative Actions	106
[G]	Class Actions	106
[H]	Relevance of Bankruptcy	107
[I]	Costs and Fees in Liability Litigation	107
VI	Indemnification	107
VII	Directors' and Officers' Insurance	107
VIII	Other Methods of Protection	108
IX	Lawyer Directorship	108
Cayman Islands		
	<i>Antony G.D. Duckworth, Alan G. de Saram & Wendy Stenning</i>	109
I	Introduction	109
II	Board Structure	110
[A]	Appointment of Directors	110
[B]	Delegation	110
[C]	Removal of Directors	110
III	Duties of Directors	111
[A]	General Duties of Directors	111
[B]	Duty of Honesty and Good Faith	111
[C]	Duties of Care and Skill	113
IV	Liability Issues	113
[A]	General Points	113
[B]	What Can Be Recovered?	113
[C]	Costs	114
V	Indemnification of Directors	114
VI	Directors' Reliance on Outside Professionals and Professionally Qualified Directors	114
VII	Winding Up	115
Chile		
	<i>Pablo Guerrero V.</i>	117
I	National Basics' and National Legal Theories of Directors' Liabilities	117
[A]	The Board of Directors	118
[B]	Composition of the Board	118
[C]	Powers of the Board and How They Are Used	118
[D]	Independent Directors and Directors' Committee	120
[E]	Executive Officers	121
II	Duties of Directors	121
[A]	Duty of Care	121
[B]	Duty of Loyalty	122
[C]	Duty of Disclosure	123
III	Directors' Liability	124

Table of Contents

IV	Directors' Insurance	125
V	Actions to Pursue Redress of the Company	125
VI	Conclusion	125
Czech Republic		
	<i>Dagmar Dubecká</i>	127
I	'National Basics' (New Civil Code and New Corporation Acts Effective since 1 January 2014)	127
	[A] Basic Powers of the Statutory Bodies	128
	[1] Board of Directors/Statutory Director	128
	[2] Supervisory Board/Administrative Council	129
	[B] Basic Duties of the Members of the Company's Statutory Bodies	130
	[C] Liability for a Breach of Duties	131
	[1] Civil Liability	131
	[2] Liability in Insolvency	132
	[3] Basic Criminal Law Aspects	133
	[D] Composition of Company Statutory Bodies, Membership and Requirements for the Performance of Office	133
	[1] Composition of Company Statutory Bodies	133
	[2] Election and Removal, Membership Requirements	133
	[3] Parallel Performance of Functions and Ban on Competition	134
	[E] Protection for Members of Company Statutory Bodies	135
Denmark		
	<i>Niels Bang</i>	137
I	The Danish Management System	137
	[A] General	137
	[B] Election of Directors and Managers	137
	[C] The Division of Power	138
II	Directors' Liability	138
	[A] Legal Prerequisites to Liability	138
	[B] Tasks and Duties	139
	[C] Directors in Listed Companies	140
III	Recent Cases Dealing with Directors' Liability	140
	[A] Introduction	140
	[B] Liability for Violation of the Companies Act	141
	[C] Liability for Predecessors' or Successors' Acts	141
	[D] Liability for Violating the Financial Statements Act	142
	[E] Duties in Pursuance of Special Legislation	143
	[F] Operation of a Company in Difficulties	143
IV	Developments in the Liability of Directors	144
V	Limitation of Liability	144
	[A] Introduction	144

Table of Contents

	[B] Agreed Exemption From Liability	144
	[C] Discharge from Liability: Adoption of Accounts	145
	[D] Reduction of Liability	145
VI	Insurance	145
	[A] Common Directors' and Officers' Liability Insurance	145
	[B] Lawyers' Liability Insurance	145
	[C] Effect of Insurance Coverage	146
Ecuador		
	<i>Javier Robalino-Orellana, Daniel Robalino Orellana, Martín Pallares Sevilla & Estefanía Alarcón</i>	147
I	National Basics and National Legal Theories of Director's Liabilities	147
	[A] Two-Tiered or Unitary Company Structure	147
	[B] Chairman/CEO	147
	[C] Board Structures	148
	[D] General Shareholders' Meetings	148
	[E] Director's Elections	149
	[F] Director's Term of Appointment	149
	[G] Removal of Directors	149
II	Typical Behavior to Avoid Director's Liability	149
III	Corporate Governance	150
	[A] Andean Community's Corporate Governance Code	150
	[B] Corporate Governance in the Banking Regulatory System	150
	[C] Ecuadorian Institution of Corporate Governance	151
IV	Liability Issues	152
	[A] "De Facto" Director	152
	[B] Limitations of Liabilities	152
	[C] Responsibility Action	153
	[D] Relevance of Bankruptcy of Corporation	154
V	Indemnification	154
VI	Director's and Officer's Insurance	155
VII	Other Methods of Protection	155
VIII	Lawyer Directorship	155
IX	Forecast on Future Legislation Development	155
Estonia		
	<i>Sven Papp & Kaspar Kolk</i>	157
I	Basic Principles for Directors' Liability	157
	[A] Corporate Governance Structure	158
	[B] Management Structure, Chairman and Delegation	159
	[C] Election and Removal of Directors	159
II	Directors' Duties and Typical Liability Cases	160
	[A] Liability vis-à-vis the Company	161

Table of Contents

	[1] Inaccurate Valuation of the Non-monetary Contribution	161
	[2] Causing the Payment of Unlawful Distribution to Shareholder	161
	[3] Payments after Insolvency Has Become Evident	162
	[4] Non-compete	162
	[5] Disclosure of Business Secrets	162
[B]	Liability under Tort Law	162
	[1] Late Filing of a Bankruptcy Petition	162
	[2] Failure to Organize Accounting	163
	[3] Failure to Provide Information to Creditors	163
[C]	Criminal Liability and Liability Arising from Specific Laws	163
III	Liability Issues	164
[A]	Enforcement of Directors' Liability	164
	[1] Who Can Sue?	164
	[a] Company	164
	[b] Bankruptcy Trustee	164
	[c] Creditors (Derivative Action)	165
	[d] Third Persons	165
	[2] Costs of Litigation and Class Actions	165
[B]	Limitations and Joint Liability of Directors	165
[C]	Indemnification and Other Methods of Protection	166
IV	Directors' and Officers' Insurance	166
V	Lawyer Directorships	167
VI	Forecast on Future Legislation Development	167
The European Action Plans of 2003 and 2012		
	<i>Thorsten M. Volz</i>	169
I	Introduction	169
II	The Scope of the European Action Plan	170
III	The Proposed Time Schedule of the European Action Plan	171
IV	The Second European Action Plan of 2012	172
V	Provisions on Directors' Liability within the European Action Plan	172
VI	The Implementation within the European Community	174
VII	The Implementation within Member States' Legislation	174
	[A] Austria	174
	[B] Belgium	175
	[C] Czech Republic	175
	[D] Denmark	175
	[E] Finland	175
	[F] France	175
	[G] Germany	176
	[H] Ireland	176
	[I] Italy	176
	[J] Luxembourg	177
	[K] Netherlands	177

Table of Contents

[L]	Poland	177
[M]	Portugal	177
[N]	Spain	177
[O]	Sweden	178
[P]	Switzerland	178
[Q]	Ukraine	178
[R]	United Kingdom	178
Finland		
	<i>Riikka Rannikko & Jesse Collin</i>	179
I	‘National Basics’ and National Legal Theories of Directors’ Liabilities	179
	[A] Company Organs	180
	[B] Board of Directors	181
	[1] Number of Board Members, Their Election, and Term of Duty	181
	[2] Duties of Board Members under the Companies Act	182
	[3] Finnish Corporate Governance Code and Finnish Panel on Takeovers and Mergers	183
II	Liability of Board Members	183
	[A] Liability under the Companies Act	183
	[B] Damage, Negligence, and Causality	185
	[C] Scope of Liability	185
	[D] Amount of Compensation and Legal Costs	185
III	Division of Liability	186
	[A] Delegation	186
	[B] Adjustment and Allocation of Damages	186
IV	Limitation of Liability	187
France		
	<i>Jacques Buhart & Nicolas Lafont</i>	189
I	“National Basics” and National Legal Theories of Directors’ Liabilities	189
	[A] Two-Tiered or Unitary Company Structure	189
	[B] Chairman and CEO (One or Two People/Checks and Balances)	189
	[1] Unitary Structure	189
	[2] Two-Tiered Structure	190
	[C] Board Structures	190
	[1] Unitary Structure	190
	[2] Two-Tiered Structure	190
	[D] Director’s Elections/Staggering	190
	[1] Unitary Structure	190
	[2] Two-Tiered Structure	191
	[E] Directors’ Term of Appointment	191
	[1] Unitary Structure	191
	[2] Two-Tiered Structure	191

Table of Contents

	[F] Delegation	191
	[G] Removal of Directors	191
	[1] Unitary Structure	191
	[2] Two-Tiered Structure	192
II	Judicial Review (Tightening of Standards?)	192
III	Corporate Governance	192
	[A] Composition of the Board of Directors/Recent Developments	192
	[1] Independent Directors	192
	[2] Parity	193
	[3] Employee Board Member	193
	[4] Vice-Chairman/Senior Director	193
	[B] Are the Decision-Making Mechanisms Changing in France in Light of Recent Developments?	193
	[C] Board/Management Relationship	194
	[1] Unitary Structure	194
	[2] Two-Tiered Structure	194
IV	Corporate Governance	194
	[A] Board Procedure	194
	[B] Structures of Oversight	195
V	Liability Issues	195
	[A] Who Can Sue?	195
	[1] Shareholders	195
	[2] The Company Itself	196
	[3] Third Parties	196
	[B] Who Can Be Sued?	196
	[1] Individual Liability	196
	[a] Civil Liability	196
	[b] Criminal Liability	196
	[2] Collective Liability	197
	[a] Collective Liability of the Board of Directors	197
	[b] Liability of Members of the Supervisory Board	197
	[C] “De Facto” Manager	197
	[D] Thresholds and Limitations/Caps of Liabilities/Caps of Liabilities in France (Statutory Limitations on Directors’ Liability)	198
	[E] Class Actions	198
	[F] Relevance of Bankruptcy of Corporation with Regard to Bringing a Directors’ Liability Suit	198
	[1] Directors’ Liability	198
	[a] Insufficiency of Assets	198
	[b] Personal Bankruptcy	199
	[c] Banqueroute	200
	[2] Liability of Supervisory Board Members	200
	[3] Costs and Fees in Litigations	200
VI	Indemnification	200

Table of Contents

VII	Directors' and Officers' Insurance	200
VIII	Lawyer Directorship	201
	[A] French Lawyers May Not Directly Run a Company	201
	[B] French Lawyers May Be Appointed as Director	201
IX	The "European Action Plan"	201
Germany		
	<i>Alexander Loos</i>	203
I	Basic Principals for Directors' Liability	203
	[A] Single-Body Companies or Two-Tier System	203
	[B] Management Structure and Chairman	204
	[C] Delegation of Management Powers	204
	[D] Removal of Directors	204
II	Typical Liability Cases	205
	[A] Internal Liability towards the Company	205
	[1] Violation of Compliance Rules	205
	[2] Violation of Non-compete	205
	[3] Poaching of Business from the Company	206
	[4] Disbursements from Restricted Equity of the Company	206
	[5] Violation of Arm's-Length Principles	207
	[6] Knowing Disregard of Avoidable Risk	207
	[B] External Directors' Liability	207
	[1] Gross Negligence to Pay Taxes and Public Levies	208
	[2] Illicit Non-payment of Social Security Contributions	208
	[3] Late Filing for Insolvency	208
III	Liability Issues	209
	[A] Enforcement of Director's Liability	209
	[1] Who Can Sue?	209
	[2] Costs of Litigation and Class Actions	210
	[B] Joint Liability of Directors	211
	[C] Indemnification	211
	[D] Time Limitation	211
IV	Directors' and Officers' Insurance	212
V	Lawyer Directorships	212
VI	The European Action Plan	212
Hong Kong		
	<i>Allan Leung & Danny Leung</i>	213
I	Introduction	213
	[A] One-System Body	214
	[B] Board Structure and Duality of Chairman and CEO	214
	[1] Board Structure	214

Table of Contents

	[2] Duality of Chairman and Chief Executive	215
	[C] Delegation	215
	[D] Elections	215
	[E] Removal of Directors	215
II	Liability Issues	216
	[A] Directors' Duties	216
	[1] Fiduciary Duties	216
	[a] Duty to Act in Good Faith in the Best Interests of the Company as a Whole	216
	[b] No Fetters on Discretion	216
	[c] Duty Not to Compete	217
	[d] Duty to Avoid a Conflict of Interest and Not to Make a Secret Profit	217
	[e] Confidentiality	217
	[2] General Duties	218
	[a] Skill, Care, and Diligence	218
	[b] Duty Not to Exceed Powers	218
	[c] Duty to Creditors	218
	[B] Who Can Sue?	218
	[1] Duties Owed to Individual Shareholder	219
	[2] Duties Owed to Creditors	219
	[C] Who Can Be Sued?	219
	[D] Derivative Actions	220
	[1] Common Law Derivative Action	220
	[2] Statutory Derivative Action	220
	[E] Unfair Prejudice	221
	[F] Representative Actions	221
	[G] Insolvency Context	222
	[1] Miffeasance	222
	[2] Fraudulent Trading	222
	[3] Disqualification Order	222
	[H] Costs and Fees in Liability Litigations	223
III	Indemnification	223
IV	Protection Against Wrongs of Directors	223
	[A] Ratification	223
	[B] Directors' and Officers' Liability Insurance	224
V	Corporate Governance	224
	[A] Existing Corporate Governance	224
	[B] Corporate Governance Reform: Difficulties in Hong Kong	224
	[1] Family-Controlled Companies	224
	[2] Quality of INEDs	225
	[C] Going Forward	225

Table of Contents

India		
<i>Som Mandal</i>		227
I	Introduction	227
	[A] Appointment of Directors	227
	[B] Shareholder Rights	228
	[C] Government's Right to Appoint Directors	228
	[D] Removal of Directors	228
	[E] Power of Directors May Be Amended	229
II	Recent Cases and Anthropological Approach to Directors' Liabilities	229
	[A] Financial Scams	230
	[B] Judiciary	231
III	Government's Approach towards Ensuring Greater Corporate Accountability	231
IV	Liability Issues	234
	[A] Officer in Default	235
	[B] Contractual Liabilities	235
	[C] Tortious Liability	235
	[D] Apprehension of Prosecution	236
	[E] Compounding Offences, a Way Out?	236
	[F] Managing Director/Whole-Time Director/Nominee Director/ Professional Director	236
	[G] Object and Scope of Section 633	237
	[H] Directors' Liability Insurance	237
Indonesia		
<i>Lia Alizia & Valdano Ruru</i>		239
I	General Legal Theories on the Board of Directors	239
	[A] Two-Tier System or One-Tier System	239
	[B] Structure of the Boards	240
	[C] Chairman/CEO	240
	[D] Appointment	240
	[E] Authorities	241
	[F] Delegation	242
	[G] Termination	242
II	Liability Issues	243
	[A] Who Can Sue?	243
	[B] Who Can Be Sued?	243
	[C] 'De Facto' Directors	243
	[D] Thresholds and Limitations/Caps on Liabilities	244
	[E] Joint Liability/Solidarity	244
	[F] Derivative Actions	244
	[G] Class Actions	244

Table of Contents

	[H] Relevance of the Bankruptcy of a Corporation	245
III	Corporate Governance	245
IV	Indemnification	245
V	Directors' and Officers' Insurance	246
VI	Lawyer Directorships	246
VII	Criminal and Civil Liabilities of Directors under the Company Law and Company Registration Law	246
	[A] Criminal	246
	[B] Civil	247
VIII	Precautions Directors Should Take to Avoid Liability	247
IX	Recent Cases Dealing with the Liability of Directors	248
	[A] The <i>Videotron</i> Case	248
	[B] The <i>PT MAJU</i> Case	249
X	Future Legislation Forecast	249
	Ireland	
	<i>Stephen Hegarty & Maeve Moran</i>	251
I	National Basics and National Theories of Directors' Liabilities	251
	[A] Two-Tiered or Unitary Company Structure	251
	[B] Chairman/CEO	251
	[C] Board Structure	252
	[D] Directors' Election/Staggering	252
	[E] Directors' Term of Appointment	252
	[F] Delegation	252
	[G] Removal of Directors	253
II	Recent Cases Dealing with Directors' Liability	253
III	Typical Schemes/Behaviour to Avoid Directors' Liability	253
IV	Corporate Governance	254
	[A] UK Code	254
	[B] Directors' Compliance Statements	254
V	Liability Issues	254
	[A] Duties & Obligations Owed by Directors	254
	[1] Compliance with the Act	254
	[2] Fiduciary Duties	255
	[3] Securities Laws	255
	[4] Other Duties/Obligations	256
	[5] Delegation of Duties or Responsibilities	257
	[B] Who Can Sue?	257
	[1] The Company	257
	[2] Members	257
	[3] Employees	258
	[4] Creditors	258
	[5] Other Parties	258

Table of Contents

[C]	Who Can Be Sued?	258
[D]	Thresholds and Limitations/Caps on Liabilities	259
[E]	Derivative Actions	259
[F]	Class Actions	260
[G]	Relevance of Bankruptcy of Corporation	260
[H]	Tribunals of Inquiry	261
VI	Indemnification	261
VII	Directors' and Officers' Insurance	261
VIII	Other Methods of Protection	261
IX	Lawyer Directorship	262
X	Forecast on Future Legislation Development	262
Israel		
	<i>Ehud Sol & Haim Machluf</i>	263
I	National Basis: The Israeli Companies Law	263
[A]	History of the Israeli Companies Law	263
[B]	The Board's Principal Role under the Law	263
[C]	The Company's Structure: Organs and Their Powers	264
[1]	The General Meeting	264
[2]	The BOD: Its Authority and Duties	265
[3]	Composition of the BOD	265
[a]	General	265
[b]	External Directors	266
[c]	Independent Directors	266
[d]	Board Committees	267
[i]	Audit Committee	267
[ii]	Compensation Committee	267
[4]	Appointment and Removal of a Director	267
[a]	Appointment of Directors	267
[b]	The Power to Dismiss a Director	267
[5]	The Chief Executive Officer	268
II	Directors' and Officers' Liability	268
[A]	Liability Towards the Company	268
[1]	Duty of Care	268
[2]	Duty of Loyalty	269
[B]	Liability Towards the Shareholders	269
[C]	Liability Towards Third Parties	269
[D]	Criminal Liability	270
[E]	Liability under Specific Laws	270
[1]	Liability under the Securities Law	270
[2]	Presumption Set Out in Various Laws Concerning Directors' and Officers' Liability	271

Table of Contents

III	Claims Against Directors and Officers	271
	[A] Type of Claims	271
	[1] Regular Action by an Individual	271
	[2] Derivative Actions	271
	[3] Class Action	271
	[B] Procedural Aspects of Shareholders' Claims	272
IV	Judicial Review: The Business Judgment Rule and the Entire Fairness Doctrine	272
V	Exemption, Indemnification, and Insurance	273
	[A] General	273
	[B] Exemption	273
	[C] Indemnification	273
	[D] D&O Insurance	274
	Italy	
	<i>Gabriele Fagnano</i>	275
I	Corporate Governance Structure and Directors' Liability	275
	[A] Traditional, Single-Body, and Two-Tier System; Structures of Internal Control	275
	[B] Appointment and Removal of Directors	276
	[C] Board Structure and Main Executive Roles	277
	[D] Delegation and Information Flow within the Board of Directors	278
	[E] Directors' Interests in Relation to Company Action	279
II	Directors' Duties and Recent Cases Dealing with Directors' Liability	279
	[A] Directors' Duties	279
	[B] Judicial Approach to Directors' Standard of Care and Diligence and Limits to Judicial Review of Directors' Business Errors: Tightening of Standards	280
III	Liability Issues	282
	[A] Who Can Sue?	282
	[1] Company Action Against Directors and Relevant Indemnification	282
	[2] Action of Company Creditors and Relevant Indemnification	283
	[3] Action of Third Parties and Individual Shareholders, Relevant Indemnification	283
	[B] Who Can Be Sued?	284
	[C] Statute of Limitations and Other Limitations of Liability	284
	[1] Statute of Limitations	284
	[2] Other Limitations	284
	[D] Joint and Several Liabilities	285
	[E] Derivative Actions and Class Actions	285
	[F] Directors' Liability Suit in the Context of Bankruptcy	286

Table of Contents

Japan		
<i>Norio Mitsuuchi</i>		287
I	Introduction	287
II	'National Basics' and National Legal Theories of Director's Liabilities	288
	[A] Basic Structures (To Have a Board or Not, Etc.)	288
	[1] KK without a Board	288
	[2] KK with a Board	288
	[a] KK with a Corporate Auditor or a Board of Corporate Auditors	288
	[b] KK with an Audit and Supervisory Committee	289
	[c] KK with Three Committees	289
	[B] CEO, President, and Other Officers	289
	[C] Structures of Boards and Committees	290
	[D] Elections	290
	[E] Director's Term of Appointment	290
	[F] Delegation	291
	[G] Removal of Directors	291
III	Judicial Review	291
	[A] Relationship between KK and Directors/Corporate Auditors/ Executive Officers	291
	[B] Business Judgment Rule	292
IV	Corporate Governance	292
	[A] Convocation of the Board	292
	[B] Resolutions	292
	[C] Structure of Oversight	292
	[D] Corporate Governance Code	293
V	Liability Issues	293
	[A] Who Can Sue?	293
	[1] Company	293
	[2] Shareholder	293
	[3] Third Party	294
	[B] Who Can Be Sued?	294
	[C] Thresholds and Limitation of Liabilities	294
	[1] Negligence Requirement	294
	[2] Exemption from Liabilities	295
	[3] Partial Exemption from Liabilities	295
	[4] Prior Exemption by Articles of Incorporation and Prior Agreement to Limit Liabilities	295
	[D] Relevance of Bankruptcy of a KK with Regard to Bringing a Directors' Liability Suit	295
	[E] Costs and Fees in Liability Litigations	296
VI	Director's and Officer's Insurance	296
VII	Lawyer Directorship	296

Table of Contents

VIII	Conclusion	296
	Latvia	
	<i>Jānis Gavars, Reinis Sokolovs & Raimonds Slaidiņš</i>	297
I	National Basics and National Legal Theories of Directors' Liabilities	297
	[A] Two-Tiered or Unitary Company Structure	297
	[B] Chairman/CEO	298
	[C] Board Structures	298
	[D] Directors' Elections/Staggering	299
	[E] Directors' Term of Appointment	299
	[F] Delegation	299
	[G] Removal of Directors	300
II	Recent Cases Dealing with Directors' Liability	300
	[A] Judgment of 15 January 2014 in Case No. SKC-101/2014 of the Civil Case Department of the Supreme Court of Republic of Latvia	300
	[B] Judgment of 27 May 2014 in Case No. SKC-102/2014 of the Civil Case Department of the Supreme Court of Republic of Latvia	301
	[C] Judgment of 13 June 2014 in Case No. 2014-02-01 of the Constitutional Court of Republic of Latvia 'On the Compliance of Para 4 of Section 17 of Deposit Guarantee Law with the First Sentence of Article 91 of the Constitution of the Republic of Latvia'.	301
III	Judicial Review (For Example, Tightening of Standards?)	301
IV	Typical Schemes/Behaviour to Avoid Directors' Liability	302
	[A] Compliance with the Principle of an Honest and Prudent Manager	303
	[B] Release from Liability by Means of a Decision of the Shareholders' Meeting	303
	[C] Good Faith Compliance with Shareholders' Decisions	303
V	Liability Issues	303
	[A] Who Can Sue?	303
	[1] Private Liability	303
	[2] Public Liability	304
	[B] Who Can Be Sued?	304
	[C] 'De Facto' Director	305
	[D] Thresholds and Limitations/Caps of Liabilities	305
	[E] Joint Liability/Solidarity	305
	[F] Derivative Actions	306
	[G] Class Actions	306
	[H] Relevance of Bankruptcy of Corporation	306
VI	Indemnification	306
VII	Directors' and Officers' Insurance	306
VIII	Other Methods of Protection	307
IX	Lawyer Directorship	307
X	Forecast on Future Legislation Development	307

Table of Contents

Luxembourg	
<i>Alexander Koch</i>	309
I	National Basics and National Legal Theories of Directors' Liabilities 309
	[A] One-Tier and Two-Tier System 309
	[B] Chairperson and CEO 310
	[C] Board Structures 311
	[D] Directors' Elections and Term of Appointment/Staggering 312
	[E] Delegation 312
	[F] Removal of Directors 313
II	Recent Cases Dealing with Directors' Liability 313
III	Judicial Review (For Example, Tightening of Standards?) 313
IV	Corporate Governance 314
V	Liability Issues 314
	[A] Who Can Sue? 315
	[1] Liability for Mismanagement (Article 59(1) of the Law) 315
	[2] Liability for Breach of the Law or the Articles of Association (Article 59(2) of the Law) 315
	[3] Liability in Tort (Articles 1382 and 1383 of the Civil Code) 315
	[4] Liability under Criminal Law 316
	[B] Who Can Be Sued? 316
	[1] Liability for Mismanagement (Article 59(1) of the Law) 316
	[2] Liability for Breach of the Law or the Articles of Association (Article 59(2) of the Law) 316
	[3] Liability in Tort (Articles 1382 and 1383 of the Civil Code) 316
	[4] Liability under Criminal Law 317
	[C] De Facto Directors 317
	[D] Thresholds and Limitations/Caps of Liabilities 317
	[E] Joint Liability/Solidarity 317
	[1] Liability for Mismanagement (Article 59(1) of the Law) 317
	[2] Liability for Breach of the Law or the Articles of Association (Article 59(2) of the Law) 318
	[3] Liability in Tort 318
	[4] Liability under Criminal Law 318
	[F] Derivative Actions 318
	[G] Relevance of Bankruptcy of the Company with Respect to Directors' Liability 319
VI	Indemnification 319
VII	Directors' and Officers' Insurance 320
VIII	Other Methods of Protection 320
	[A] Discharge 320
	[B] Resignation 320
IX	Forecast on Future Legislation Development 321

Table of Contents

Mexico		
	<i>Daniel Del Rio & Juan José López-de-Silanes</i>	323
I	Introduction	323
	[A] Investment Promotion Companies (“ <i>Sociedades Anonimas Promotoras de Inversion</i> ”)	323
	[B] Stock Exchange Investment Promotion Companies (“ <i>Sociedades Anonimas Promotoras de Inversion Bursatil</i> ”)	324
	[C] Stock Exchange Companies (“ <i>Sociedades Anonimas Bursatiles</i> ”)	324
II	“National Basics” and National Legal Theories of Directors’ Liabilities	324
	[A] Two-Tier System or One-Tier System	324
	[B] Chairman and CEO (One or Two People/Checks and Balances)	325
	[C] Board Structures	326
	[D] Elections/Staggering	326
	[E] Delegation	326
	[F] Removal of Directors	327
III	Judicial Review (For Example Tightening of Standards?)	327
IV	“Socio-Anthropological Issues”	327
	[A] Is the Composition of the Board of Directors Changing in Mexico in Light of Recent Developments?	327
	[B] Are the Decision-Making Mechanisms Changing in Mexico in Light of Recent Developments?	328
	[C] Board/Management Relationship	328
V	Corporate Governance	328
	[A] Board Procedures	328
	[B] Structures of Oversight	328
VI	Liability Issues	329
	[A] Who Can Sue?	329
	[B] Who Can Be Sued?	330
	[C] Thresholds and Limitations/Caps of Liabilities in Mexico: Statutory Limitations on Directors’ Liability	330
	[D] Joint Liability/Solidarity	330
	[E] Derivative Actions	331
	[F] Class Actions	331
	[G] Relevance of Bankruptcy of Corporation with Regard to Bringing a Directors’ Liability Suit	332
	[H] Costs and Fees in Liability Litigation	332
VII	Indemnification	332
VIII	Directors’ and Officers’ Insurance	332
IX	Other Methods of Protection	333
X	Lawyer Directorship	333
XI	The “European Action Plan”	333

Table of Contents

Mongolia	
<i>Chris Melville, Anthony Woolley & Ariungoo Khurelbaatar</i>	335
I National Basics	335
[A] Three-Tiered Corporate Governance System	336
[B] Chairman/Chief Executive Officer	338
[C] Board Structure	338
[D] Directors' Elections	338
[E] Directors' Term of Appointment	339
[F] Delegation	339
[G] Removal of Directors	339
II Recent Cases Dealing with Directors' Liability	339
III Judicial Overview	339
IV Corporate Governance	340
V Liability Issues	341
[A] Who Can Be Sued?	341
[B] Who Can Sue?	341
[C] 'De Facto' Directors	342
[D] Thresholds and Limitations/Caps of Liabilities	342
[E] Joint and Several Liability	342
[F] Derivative Actions	342
[G] Class Actions	342
[H] Relevance of Bankruptcy of Corporation	342
VI Indemnification	343
VII Directors' and Officers' Insurance	343
VIII Other Methods of Protection	343
IX Lawyer Directorship	344
X Forecast on Future Legislation Development	344
The Netherlands	
<i>Willem Calkoen & Martin Grablowitz</i>	345
I 'National Basics'	345
[A] Two-Tier System or One-Tier System	345
[B] Chairman and CEO	346
[C] Board Structures	346
[D] Elections/Staggering	346
[E] Delegation	347
[F] Removal of Directors	347
II Directors' Liability	347
III 'Socio-Anthropological Issues'	348
[A] Composition of the Board of Directors	348
[B] Decision-Making Mechanism	348
[C] Board/Management Relationship	349
IV Corporate Governance Code	349

Table of Contents

V	Liability Issues	350
	[A] Who Can Sue?	350
	[1] The Company	350
	[2] The Shareholder	350
	[3] Trustee in Bankruptcy	350
	[4] Creditors and Third Parties	351
	[5] The Government	351
	[B] Who Can Be Sued?	351
	[C] Thresholds and Limitations/Caps of Liabilities in the Netherlands (Statutory Limitations on Directors' Liability)	351
	[D] Joint Liability/Solidarity	351
	[E] Derivative Actions	352
	[F] Class Actions	352
	[G] Relevance of Bankruptcy of Corporation with Regard to Bringing a Directors' Liability Suit	353
	[H] Costs and Fees in Liability Litigations	353
VI	Indemnification	353
VII	Directors' and Officers' Insurance	354
VIII	Lawyer Directorship	354
IX	Pending Legislation	354
New Zealand		
	<i>Pip England</i>	355
I	'National Basics' and National Legal Theories of Directors' Liabilities	355
	[A] Two-Tiered or Unitary Company Structure?	355
	[B] Definition of 'Director'	356
	[C] Separation of Chairperson and CEO	356
	[D] Board Structures	356
	[E] Directors' Elections/Staggering	357
	[F] Directors' Term of Appointment	357
	[G] Delegation	357
	[H] Disclosure of Conflicts of Interest	357
	[I] Removal of Directors	358
II	Recent Cases Dealing with Directors' Liability	358
	[A] Reckless Trading	358
	[B] Directors' Duties	359
	[C] Silent Directors	360
	[D] Directors of Finance Companies	360
III	Judicial Review (Tightening of Standards?)	360
IV	Corporate Governance	361
	[A] Overview of New Zealand Governance	361
	[B] FMA Corporate Governance Handbook	361
	[C] NZX Discussion Document	362
	[D] Use of Board Committees	362

Table of Contents

	[E] Other Oversight Structures	363
V	Liability Issues	363
	[A] Who Can Sue?	363
	[1] The Company	363
	[2] Shareholders	364
	[3] Creditors	364
	[4] Regulatory Bodies	364
	[B] Who Can Be Sued?	365
	[C] Statutory Limitations on Directors' Liability	365
	[D] Joint Liability	365
	[E] Derivative Actions	365
	[F] Class Actions	365
	[G] Relevance of Liquidation	366
	[H] Costs in Liability Litigation	366
VI	Indemnification and Insurance	366
	[A] Indemnity	366
	[B] Insurance	367
VII	Forecast on Future Legislation Development	367
Nigeria		
	<i>Ayodeji Oyetunde & Lotanna Nwodo</i>	369
I	Overview of Nigeria's Corporate Governance Regulation	369
II	National Basics and National Legal Theories of Directors' Liabilities	369
	[A] Unitary Company Structure	369
	[B] Separation of Chairman and CEO	370
	[C] Board Structures	370
	[D] Directors Elections/Staggering and Term of Appointment	371
	[E] Delegation	371
	[F] Removal of Directors	372
III	Liability Issues	373
	[A] Duties of a Director	373
	[B] Who Can Sue?	373
	[C] Who Can Be Sued?	374
	[D] De Facto Director	374
	[E] Thresholds and Limitations/Caps of Liabilities	374
	[F] Joint Liabilities	375
	[G] Derivative Actions	375
	[H] Class Actions	375
	[I] Liabilities of Directors on Winding Up	375
IV	Recent Cases Dealing with Directors' Liability	376
	[A] Joint Responsibility of the Board	376
	[B] Misappropriation of Funds	376
	[C] Duty to Render Accurate Accounts	376
V	Judicial Review	377

Table of Contents

VI	Schemes/Behaviours to Avoid Directors' Liability	377
VII	Indemnification and Liability Insurance	377
VIII	Lawyer Directorship	378
IX	Forecast on Future Legislation Development	378
The People's Republic of China		
<i>Liang Xu & Sarah Zhang</i>		379
I	Introduction	379
	[A] Three-Tiered Corporate Governance Body	379
	[1] Shareholders	380
	[2] Board of Directors or Executive Director	380
	[3] Board of Supervisors	381
	[B] Board Structure and Concurrent Offices	381
	[1] Board Structure	381
	[2] Concurrent Office	381
	[C] Delegation	382
	[D] Elections	382
	[E] Removal of Directors	382
	[F] Qualification of Directors	383
II	Liability Issues	383
	[A] Directors' Duties	383
	[1] Fiduciary Duty	383
	[2] General Duties	384
	[3] Legal Representative	384
	[4] Apparent Authority	385
	[B] Who Can Sue?	385
	[1] Duties Owed to the Company	385
	[2] Duties Owed to Shareholders	385
	[3] Duties Owed to Creditors	386
	[C] Who Can Be Sued?	386
	[D] Derivative Actions by Shareholders	386
	[E] Unfair Prejudice	386
	[1] Compulsory Buy Back	386
	[2] Compulsory Winding Up	387
	[F] Representative Actions	387
	[G] Liquidation Context	387
	[H] Costs and Fees in Liability Litigations	388
III	Indemnification	388
IV	Protection Against Wrongs of Directors	388
	[A] Ratification	388
	[B] Directors' and Officers' Liability Insurance	388
V	Corporate Governance	388

Table of Contents

Poland	
<i>Tomasz Żak</i>	391
I	'National Basics' and National Legal Theories of Directors' Liability 391
	[A] Two-Tiered or Unitary Company Structure 391
	[B] Chairman and CEO 392
	[C] Board Structure 392
	[D] Directors' Election/Staggering 392
	[E] Directors' Term of Appointment 393
	[F] Delegation of Powers 393
	[G] Removal and Suspension of Directors 393
II	Typical Schemes/Behaviour to Avoid a Directors' Liability 394
III	Corporate Governance 394
	[A] Management Board 394
	[B] Supervisory Board 395
IV	Liability Issues 395
	[A] Liability Towards the Company 395
	[B] Liability Towards Third Parties 396
	[C] Derivative and Class Actions 398
	[D] Costs 399
	[E] Criminal Liability 399
V	Indemnification 399
	[A] Liability Towards Third Parties 399
	[B] Liability Towards the Company 399
VI	Directors' and Officers' Insurance 400
VII	Lawyer Directorship 400
Portugal	
<i>Miguel de Avillez Pereira & Hugo Teixeira</i>	401
I	National Basics and National Legal Theories of Directors' Liabilities 401
	[A] Two-Tiered or Unitary Company Structure 401
	[B] Chairman/CEO 402
	[C] Board Structures 402
	[D] Directors' Elections/Staggering/Term of Appointment 402
	[E] Delegation 403
	[F] Removal of Directors 403
II	Recent Cases Dealing with Directors' Liability 404
III	Judicial Review (For Example, Tightening of Standards?) 404
IV	Typical Schemes/Behaviour to Avoid Directors' Liability 405
V	Corporate Governance 406
VI	Liability Issues 406
	[A] Who Can Sue? 407
	[1] Liability Towards the Company 407
	[2] Liability Towards Shareholders (and Other Third Parties) 407

Table of Contents

	[3] Liability Towards Creditors of the Company	407
	[4] Liability Before Tax Authorities and Social Security	407
	[B] Who Can Be Sued?	408
	[C] The De Facto Directors	408
	[D] Thresholds and Limitations/Caps of Liabilities	408
	[E] Joint Liability/Solidarity	408
	[F] Derivative Actions	409
	[G] Class Actions	409
	[H] Relevance of Bankruptcy of Corporation	409
VII	Indemnification	409
VIII	Directors' and Officers' Insurance	410
IX	Other Methods of Protection	410
X	Lawyer Directorship	410
XI	Forecast on Future Legislation Development	410
The Russian Federation		
<i>Doran Doeh & Svetlana Barinova</i>		
		411
I	“National Basics” and National Legal Theories of Directors' Liabilities	412
	[A] Two-Tier or Unitary Company Structure	412
	[B] Chairman/General Director	412
	[C] Board Structures	412
	[D] Election of Directors	413
	[E] Directors' Term of Appointment	413
	[F] Delegation	413
	[G] Removal of Directors	414
II	Recent Cases Dealing with Directors' Liability	414
III	Judicial Review (Tightening of Standards?)	414
IV	Typical Schemes/Behavior to Avoid Directors' Liability	415
V	Corporate Governance	415
VI	Liability Issues	415
	[A] Who Can Sue?	416
	[B] Who Can Be Sued?	416
	[C] “De Facto” Director	417
	[D] Thresholds and Limitations/Caps of Liabilities	417
	[E] Joint Liability/Solidarity	417
	[F] Derivative Actions	417
	[G] Class Actions	418
	[H] Relevance of Bankruptcy of Corporation with Regard to Bringing a Director's Liability Suit	418
VII	Indemnification	418
VIII	Directors' and Officers' Insurance	419
IX	Lawyer Directorship	420
X	Forecast on Future Legislation Development	420

Table of Contents

Singapore		
<i>Stephanie Keen & Matthew Bousfield</i>		421
I	'National Basics' and National Legal Theories of Directors' Liabilities	421
	[A] Two-Tiered or Unitary Company Structure	422
	[B] Directors' Duties	422
	[C] Chairman and CEO	423
	[D] Board Structures	423
	[E] Directors' Elections	424
	[F] Directors' Term of Appointment	424
	[G] Delegation	425
	[H] Removal of Directors	425
II	Recent Cases Dealing with Directors' Liability	425
	[A] <i>Lim Weng Kee v. Public Prosecutor</i>	425
	[B] <i>Ho Kang Peng v. Scintronix Corp Ltd</i> (Formerly Known as TTL Holdings Ltd)	426
	[C] <i>Falmac Limited v. Cheng Ji Lai Charlie</i>	426
III	Corporate Governance	426
	[A] Independent Directors	426
	[B] Executive and Non-executive Directors	427
	[C] Oversight Committees	427
IV	Liability Issues	428
	[A] Who Can Sue?	428
	[B] Who Can Be Sued?	428
	[C] De Facto Directors	428
	[D] Thresholds and Limitations on Directors' Liabilities	429
	[E] Joint/Several Liability	429
	[F] Derivative Actions	429
	[G] Class Actions	430
	[H] Relevance of Bankruptcy of the Corporation	430
V	Indemnification and Insurance	430
VI	Other Methods of Protection	431
VII	Legislation Development	431
South Africa		
<i>Nastascha Harduth, Eric Levenstein, David Gewer & Derek Alexander</i>		433
I	Introduction	433
II	National Basics and National Legal Theories of Directors' Liabilities	434
	[A] Board Structures	434
	[B] Chairperson and Chief Executive Officer	434
	[C] Directors' Election, Staggered Rotation and Terms of Appointment	435
	[D] Delegation and Board Committees	435
	[E] Removal of Directors	436
III	Recent Cases Dealing with Directors' Liability	437

Table of Contents

IV	Socio-Anthropological Issues	438
V	Behaviour to Avoid Director's Liability	439
VI	Liability Issues	440
	[A] Who Can Sue and Who Can Be Sued	440
	[B] The 'De Facto' Director	440
	[C] Joint Liability	441
	[D] Derivative Actions	441
	[E] Insolvency and Financial Distress	441
VII	Indemnification, Directors' and Officers' Insurance, Other Methods of Protection	441
VIII	Lawyer Directorship	442
IX	Forecast on Future Legislation Development	442
	South Korea	
	<i>Kyung-Taek Jung & Hye-Sung Kim</i>	445
I	National Basics and Legal Theories of Directors Liabilities	445
	[A] Two-Tiered or Unitary Company Structure	445
	[B] Representative Director/Executive Officer	445
	[C] Board Structures	446
	[D] Director's Elections/Staggering	446
	[E] Director's Term of Appointment	447
	[F] Delegation	447
	[G] Removal of Directors	447
	[H] Duties of Directors	447
	[1] Duty of Care	447
	[2] Duty of Loyalty	447
	[3] Duty of Confidentiality	448
	[4] Duty of Non-compete with the Company	448
	[5] Duty Against Usurpation of Business Opportunity of the Company	448
	[6] Duties as to Transactions between Directors and the Company (i.e., Self-Dealing)	448
	[7] Duty to Report to Audit Committee	449
II	Recent Cases Dealing with Directors' Liability	449
III	Judicial Review	450
IV	Typical Schemes/Behavior to Avoid Directors' Liability	450
V	Corporate Governance	451
	[A] General Principles of Corporate Governance in Korea	451
	[B] Recent Developments in the Law, Codes and Rules of Corporate Governance	451
	[C] The Law Enforcement Agency in Charge of Enforcing Corporate Governance in Korea	452
VI	Liabilities Issues	452
	[A] Who Can Sue & Who Can Be Sued?	452

Table of Contents

[B]	De Facto Director	453
[C]	Thresholds and Limitations/Caps of Liabilities	453
[D]	Joint Liability/Solidarity	453
[E]	Shareholders' Derivative Actions	453
[F]	Class Actions	454
[G]	Relevance of Bankruptcy of Corporation	454
VII	Indemnification of Directors' Liability	454
VIII	Directors' and Officers' Insurance	454
IX	Lawyer Directorship	455
X	Forecast on Future Legislation Development	455
Spain		
	<i>Enric Picanyol & Coro Fernández-Rañada</i>	457
I	'National Basics' and Legal Theories on Directors' Liabilities	457
[A]	Two-Tier versus 'One-System' Body	457
[B]	Chairman/CEO	458
[C]	Board Structure	458
[D]	Elections/Staggering	458
[E]	Delegation	459
[F]	Removal of Directors	459
II	Recent Cases Dealing with Directors' Liabilities	459
[A]	General Rules	459
[B]	Liability for Corporate Debt	459
III	Judicial Review	460
IV	Socio-Anthropological Issues	461
V	Corporate Governance	461
VI	Liability Issues	462
[A]	Who Can Sue?	462
[1]	Corporate Action	462
[2]	Individual Action	462
[B]	Who Can Be Sued?	463
[1]	Directors	463
[2]	Corporate Entities as Directors	463
[3]	De Facto Directors	463
[4]	Liquidators	463
[5]	Persons Holding Powers of Attorney	463
[C]	Thresholds and Limitations	464
[1]	Time-Barring Term	464
[2]	Negligence	464
[D]	Joint Liability/Solidarity	464
[E]	Derivative Actions	465
[F]	Class Actions	465
[G]	Directors' Liability in the Event of Insolvency	465
VII	Indemnification	466

Table of Contents

VIII	Directors' and Officers' Insurance	467
IX	Lawyer Directorship	467
Sweden		
	<i>Björn Kristiansson & Per Samuelsson</i>	469
I	'National Basics' and National Legal Theories of Directors' Liabilities	469
	[A] Forms of Association and Legal Context	469
	[B] Company Structure and Representation	470
	[C] Board Structure	470
	[D] Directors' Election and the Nomination Committee	471
	[E] Directors' Term of Appointment and Removal of Directors	471
II	Recent Cases Dealing with Directors' Liability	472
III	Judicial Review	472
IV	Corporate Governance	473
	[A] Legal Framework	473
	[B] Directors' Duties Towards the Company	473
	[C] Directors' Duties Towards Majority and Minority Shareholders	474
	[D] Directors' Duties in Case of Bankruptcy	475
V	Liability Issues	475
	[A] Who Can Be Sued?	475
	[B] Who Can Sue?	476
	[1] The Company	476
	[2] Shareholders: Derivative Actions	476
	[3] Creditors and Other Third Parties	476
	[C] 'De Facto' Directors' Liability	477
	[D] Limitations	477
	[E] Class Actions	477
VI	Indemnification and Directors' Insurance	477
VII	Other Methods of Protection	478
VIII	Lawyer Directorship	478
IX	Forecast on Future Legislation Development	478
Switzerland		
	<i>Matthew T. Reiter & Lorenz Naef</i>	479
I	Directors' Liability in Switzerland: The Basic Legal Regime	479
	[A] Introduction	479
	[B] Flexible One-Tier System	480
	[C] Board Structures, Chairman and CEO	480
	[D] Election and Removal of Directors, Nationality and Domicile Requirements	481
	[E] Delegation	481
II	Recent Cases Dealing with Directors' Liability	482
	[A] Claims of the Company in Good Standing	483

Table of Contents

	[B] Late Filing for Insolvency	484
	[C] Liability for the Issuance of Prospectuses	484
III	Standards of Judicial Review	485
IV	Corporate Governance	485
V	Liability Issues	485
	[A] Grounds for Liability and Prerequisites in General	485
	[B] Who Can Sue?	486
	[C] Derivative Actions in Particular	487
	[D] Who Can Be Sued?	488
	[E] No Thresholds and Limitations on Directors' Liability	488
	[F] Joint and Several Liability	489
	[G] Class Actions	489
	[H] Costs and Fees in Liability Litigations	489
VI	Indemnification	490
VII	Directors' and Officers' Insurance	490
VIII	Other Methods of Protection for Directors on the Board of a Swiss Corporation	491
Turkey		
	<i>Serdar Paksoy & assisted by Deniz Özkan</i>	493
I	Introduction	493
II	Who Can Be Elected as Director?	493
	[A] Becoming a Director	493
	[B] Qualifications of Directors	494
III	Composition of the Board	494
IV	Fiduciary Duties of Directors	495
V	Liabilities of Directors	496
	[A] Situations in Which Directors Are Held Liable	496
	[1] Incorrect Payments of the Shareholders for Their Capital Contributions	496
	[2] Unlawful Documents and Statements of the Company	497
	[3] Non-existing or Unduly Kept Corporate Books and Company Records	497
	[4] Shareholders Resolutions That Are Not Implemented without a Just Cause	497
	[5] Directors' Deliberate or Negligent Failure to Perform Other Duties Delegated by the TCC or the Articles of Association	498
	[6] Failure to Appoint Capable Executives	498
	[B] Liability of Legal Entity Directors and Their Representatives	498
	[C] Differentiated Joint Liability Principle	498
	[D] Who Can Sue the Directors?	499
	[1] Company	499
	[2] Shareholders	499
	[3] Third-Party Claims	499

Table of Contents

[E]	Directors' Liability Insurance	500
[F]	Liability of Directors under the CML	500
[G]	Liabilities of Directors Arising Out of Extraordinary Transactions	500
	[1] Capital Increases	500
	[2] Issuing Bonds	501
	[3] Liability in Case of Bankruptcy	501
[H]	Liability of Directors under the Tax Laws	501
[I]	Liability of Directors under Social Security Law	502
[J]	Liability of Directors under the Banking Law	502
[K]	Liability of Directors under Criminal Law	502
VI	Defences of Directors	502
VII	Ceasing to Be a Director	502
Ukraine		
	<i>Timur Bondaryev, Pavlo Khodakovsky & Alesya Pavlynska</i>	505
I	'National Basics' and National Legal Theories of Directors' Liabilities	505
	[A] Two-Tiered or Unitary Company Structure	505
	[B] Chairman/CEO Executive Body	506
	[C] Board Structures	506
	[D] Directors' Elections	507
	[E] Directors' Term of Appointment	507
	[F] Delegation of Authorities (Powers)	507
	[G] Removal of Directors (Dismissal, Recalling and Suspension)	508
II	Recent Cases Dealing with Directors' Liability	508
III	Judicial Review	509
IV	Typical Schemes/Behaviour to Avoid Directors' Liability	509
V	Corporate Governance	510
VI	Liability Issues	510
	[A] Who Can Sue?	511
	[B] Who Can Be Sued?	511
	[C] 'De Facto' Director	512
	[D] Thresholds and Limitations/Caps of Liabilities (Limits of Directors' Liability)	512
	[E] Joint Liability/Solidarity	513
	[F] Derivative Actions	513
	[G] Class Actions	513
	[H] Relevance of Bankruptcy of Corporation	513
VII	Indemnification	514
VIII	Directors' and Officers' Insurance	514
IX	Other Methods of Protection	514
X	Lawyer Directorship	514
XI	Forecast on Future Legislation Development	515

Table of Contents

United Arab Emirates	
<i>Imtiaz Shah</i>	517
I UAE Legal Regime	517
[A] Introduction	517
[B] Free Zones	517
[C] Permitted Corporate Vehicles	518
II 'National Basics' and National Legal Theories of Directors' Liabilities	519
[A] Company Structure	519
[B] Chairman/CEO	519
[C] Board Structures	520
[D] Directors' Elections	520
[E] Directors' Term of Appointment	521
[F] Delegation	521
[G] Removal of Directors	521
III Corporate Governance	521
[A] Decision 518	522
IV Liability Issues	523
[A] General Concept	523
[1] General Liabilities: Onshore Companies	523
[2] Criminal/Other Liabilities: Onshore	524
[3] General Liabilities: DIFC Companies	524
V Who Can Sue?	525
VI 'De Facto' Director	525
VII Threshold and Limitations/Caps of Liabilities	526
VIII Relevance of Bankruptcy of Corporation	526
IX Indemnification	526
X D&O Insurance	526
XI Forecast on Future Legislation Development	527
United Kingdom	
<i>Karla Dudek</i>	529
I 'National Basics' and National Legal Theories of Directors' Liabilities	529
[A] Two-Tiered or Unitary Company Structure	529
[B] Chairman and CEO	530
[C] Board Structures	530
[D] Directors' Elections/Staggering	531
[E] Directors' Term of Appointment	531
[F] Delegation	531
[G] Removal of Directors	532
II Recent Cases Dealing with Directors' Liability	532
III Judicial Review	533
IV Typical Schemes/Behaviour to Avoid Directors' Liability	534
V Corporate Governance	534

Table of Contents

	[A] Board Procedures	534
	[B] Structure of Oversight	535
VI	Liability Issues	535
	[A] Who Can Sue?	535
	[B] Who Can Be Sued?	536
	[C] ‘De Facto’ Director	536
	[D] Thresholds and Limitations/Caps of Liabilities	537
	[E] Joint Liability/Solidarity	537
	[F] Derivative Actions	537
	[G] Class Actions	538
	[H] Relevance of Bankruptcy of the Corporation	538
VII	Indemnification	539
VIII	Directors’ and Officers’ Insurance	539
IX	Other Methods of Protection	539
X	Lawyer Directorship	540
XI	Forecast on Future Legislation Development	540
	United States of America	
	<i>Robert Ripin</i>	541
I	National Framework for US Corporate Boards	541
	[A] Regulatory Structure	541
	[B] Board Composition	541
	[1] Board and Corporate Structure	541
	[2] Number of Directors	542
	[3] Age and Nationality Restrictions	542
	[4] Independence	542
	[C] Multiple Roles	542
	[D] Board Procedures	542
	[E] Board Elections	543
	[1] Classified Boards	543
	[2] Cumulative Voting	543
	[3] Staggered Board	543
	[4] Weighted Voting	543
	[F] Delegation	543
	[G] Removal of Directors	544
II	Standards Applicable to Directors	544
	[A] General Duties	544
	[B] State Statute, Securities Exchange, and Common Law Duties	544
	[1] Duty of Care	544
	[2] Duty of Loyalty	545
	[3] Business Judgment Rule	545
III	Cases Dealing with Directors’ Liabilities	545
	[A] Quadrant/Gheewalla	545
	[B] Krasner	545

Table of Contents

	[C] WorldCom/Enron/Emerging Communications	546
	[D] Disney/Van Gorkom	546
	[E] Observations/Recommendations	547
IV	Corporate Governance	548
	[A] Regulation	548
	[B] Board Composition/Independence	548
	[1] Independence of Majority of Board Members	548
	[2] Application to Foreign Private Issuers	549
	[3] Corporate Governance Guidelines/Code of Ethics	549
	[C] State Law Requirements (Delaware)	549
V	Liability Issues	549
	[A] Who Can Sue?	549
	[1] Shareholder Derivative Lawsuits	549
	[2] Creditors' Rights	550
	[3] Regulator Actions	550
	[B] Grounds for Liability	550
	[1] Criminal and Civil Liability	550
	[2] Securities Law	550
	[3] Antitrust	551
	[4] Theft and Fraud	551
	[5] Other	551
	[C] Thresholds and Limitations/Caps of Liabilities	551
	[D] Shareholder Liability	551
VI	Indemnification	551
VII	Insurance	552
	Vietnam	
	<i>Jeff Olson & Minh Nguyen</i>	553
I	“National Basics” and National Legal Theories of Directors’ Liabilities	553
	[A] Legal Framework and the Enterprise Law	553
	[B] Company Forms under the Enterprise Law and Two-Tiered or Unitary Company Structure	554
	[1] Limited Liability Company	554
	[2] Joint Stock Company	555
	[C] Definition of “Director”	556
	[D] Chairman/CEO (General Director)	556
	[E] Board Structures	557
	[F] Directors’ Elections/Staggering and Directors’ Term of Appointment	557
	[G] Delegation	558
	[H] Removal of Directors	558
II	Recent Cases Dealing with Directors’ Liability	559
III	Judicial Review	559
IV	Typical Schemes/Behavior to Avoid Directors’ Liability	560
V	Corporate Governance	560

Table of Contents

VI	Liability Issues	560
	[A] Who Can Sue?	561
	[B] Who Can Be Sued?	561
	[C] “De Facto” Director	561
	[D] Thresholds and Limitations/Caps of Liabilities	562
	[E] Joint Liability/Solidarity	562
	[F] Derivative Actions	562
	[G] Class Actions	562
	[H] Significance of Bankruptcy of Corporation	563
VII	Indemnification	563
VIII	D&O Insurance	563
IX	Other Methods of Protection	563
X	Lawyer Directorship	563
XI	Forecast on Future Legislation Development	563
	Index	565

Hong Kong

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I INTRODUCTION

Hong Kong is a common law jurisdiction, with laws generally derived from English law.

The main sources are the Companies Ordinance¹ and case law. Since 1997 (when Hong Kong was handed back to China), English cases no longer bind the Hong Kong courts, but commonwealth cases remain persuasive, and pre-1997 cases are still good law.

From March 2014, a new legal framework for the incorporation and operation of companies has been in effect, following a comprehensive rewrite of the Companies Ordinance. Some of the major changes under the new Companies Ordinance relate to directors' duties.

The Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the Listing Rules) impose additional regulation on companies listed on the Hong Kong Stock Exchange. The Securities and Futures Ordinance (the SFO) is relevant to corporate entities that are involved in the sale or trading of securities.

The Articles of Association (Articles) of a company is a fundamental constitutional document of the company which governs the rights and obligations of that particular company and its internal operations. Under the old Companies Ordinance, companies were also required to file a Memorandum of Association, which set out its objects clause, but this requirement has now been abolished and an existing company's Memorandum is deemed to form part of its Articles.

There are also various best practice guidelines which, although not legally binding, are nonetheless useful in ascertaining the standard of care expected of company officers, and may be referred to by the court in determining liability issues.

1. Cap. 622.

The provisions governing corporate insolvency were not updated along with the Companies Ordinance and remained untouched but renamed as the Companies (Winding Up and Miscellaneous Provisions) Ordinance Cap. 32 (the CWUMPO). The corporate insolvency law is the subject of a separate review exercise that commenced in November 2011. In October 2015, a bill was introduced into the Legislative Council for scrutiny. It is expected to undergo several amendments before entering into force in a few years' time.

[A] One-System Body

Hong Kong follows the English 'one-system body' and thus there is no supervisory committee to oversee the board of directors (hereinafter 'Board'). The Board is a self-monitoring entity, and is only accountable to the company. As we will see later in this chapter, save for a few exceptions, only the company can bring an action against its directors for wrongs inflicted by the directors.

[B] Board Structure and Duality of Chairman and CEO

The Companies Ordinance requires that a private company must have at least one director, who is a natural person.² A public company or a company limited by guarantee is required to have at least two directors.³ Corporate directors are not permitted for public companies, private companies in a group including a listed company, or companies listed by guarantee.

The Listing Rules further require that every listed company must have at least three independent non-executive directors (INEDs), representing at least one-third of the board. At least one of the INEDs must have appropriate professional qualifications or accounting or related financial management expertise.⁴

[1] Board Structure

There are no requirements for the structure of the Board of a private company, unless the Articles otherwise provide. Private companies are often seen as quasi-partnerships and directors are normally beneficial owners of those companies. In this regard, directors may be much more like business partners than a management team.

For listed companies, the Board would normally comprise of INEDs, executive directors, and non-executive directors.

2. Section 457 Companies Ordinance.

3. Section 453 Companies Ordinance.

4. Rules 3.10 and 3.10A the Listing Rules.

[2] Duality of Chairman and Chief Executive

There is no legal requirement for a company to have a chairman, but the Model Articles make provision for the appointment of a chairperson to chair the Board.

For Listed companies, the *Corporate Governance Code of the Listing Rules*⁵ provides that the two key aspects of management aspects – the management of the board and the day-to-day management of the business be divided and not concentrated in any one individual. Accordingly, the roles of Chairman and Chief Executive should not be performed by the same individual and the division of responsibilities should be clearly established.

[C] Delegation

The Articles generally provide for the delegation of the Board's powers. In a private company, members of the Board are normally business partners and therefore delegation of the Board's powers to a particular individual may not be desirable.

By contrast, it is common for the Board of a listed company to delegate its powers to an executive director, often the managing director who is either a substantial shareholder or a nominee appointed by the substantial shareholders of the listed company.

[D] Elections

The procedures for appointing a director to the company are normally provided in the company's Articles. However, the Companies Ordinance places a number of restrictions on who may be appointed as a director, including restrictions on age and persons subject to a disqualification order, and bodies corporate.

The Articles generally confer powers to members in a general meeting to appoint directors, increase or decrease the number of directors, determine their rotation, fill a casual vacancy, and appoint additional directors by passing an ordinary resolution. The Board also enjoys specific powers to appoint a director to fill a casual vacancy and to appoint additional directors.

[E] Removal of Directors

The Companies Ordinance provides that a company may by ordinary resolution remove a director before the expiration of his or her period of office, despite anything in its Articles or in any agreement between it and him or her. However, the removal of a director may be subject to any contract of service between the company and the relevant director.

5. Appendix 14 the Listing Rules at A.2.

II LIABILITY ISSUES

[A] Directors' Duties

A director has some of the characteristics of an agent and some of the characteristics of a trustee. The duties of a director can generally be divided into fiduciary duties and general duties. While much of the law in this area is derived from case law and is complex, we set out the general principles below.

The Companies Ordinance⁶ now codifies the general duties of a director to exercise reasonable care, skill and diligence, though they remain in fact unchanged from the previous position at common law. The mixed objective and subjective test for the standard of a director's duty to exercise reasonable care, skill and diligence is also now codified. The fiduciary duties of directors, which are generally based on equitable principles, remain uncodified.

There are also several non-statutory guidelines on the roles and duties of directors. For example, the Companies Registry 'A Guide on Directors' Duties'⁷ outlines the general principles for a director in the performance of his or her functions and exercise of his or her powers.

[1] Fiduciary Duties

[a] *Duty to Act in Good Faith in the Best Interests of the Company as a Whole*

A director must act honestly and in good faith, in what he or she considers to be in the best interests of the company (meaning for this purpose the shareholders as a general body), and must exercise his or her powers for the proper purpose and not for any collateral purpose. This may involve balancing the interests of present and future shareholders.

The directors' duties are owed to the company in which they hold office. This may be problematic where the company is a member of a group. Consideration of what is in the best interests of the company may involve consideration of what is in the interests of the overall group, to the extent the group interests can be said to benefit, indirectly, the company. However, the directors should not assume that the interests of the company and the group are always identical.

[b] *No Fetters on Discretion*

As a general rule, a director must not agree in advance to exercise his or her discretion in a company matter in a particular way, or in any way that would compromise his or her duty to make an independent judgment. In certain circumstances, however, directors may restrict their discretion in the best interests of the company, for example,

6. Section 465 Companies Ordinance.

7. Published March 2014.

in committing themselves to particular actions in the future in order to enable the company to enter into a contract which is in the best interests of the company at the time.

[c] Duty Not to Compete

Although there is no legal prohibition on a person acting as a director of two directly competing companies, the duty of confidentiality and duty to act in the best interests of a company make it very difficult in practice for a director to sit on the Board of two such companies.

[d] Duty to Avoid a Conflict of Interest and Not to Make a Secret Profit

A director should avoid putting him- or herself in a position where his or her own interests conflict with those of the company. However, such conflict commonly arises where a director has an interest in a particular contract being contemplated by the Board to enter into for the company or where he or she has acquired a business opportunity for him- or herself by virtue of his or her office as director. Directors must not make a 'secret profit' by misapplying the company's property, or by exploiting for their own benefit confidential information or a corporate opportunity that came to them by virtue of the position of director. If a director does make a secret profit, then he or she is under a duty to account to the company for it, unless the company has approved his or her actions by ordinary resolution at a general meeting with full knowledge of the facts.

In furtherance of these general principles, the Companies Ordinance requires directors to disclose any interests in transactions, and prohibits transactions with connected entities or certain payments to directors without shareholder approval.

[e] Confidentiality

Directors must not misuse or disclose for unauthorized purposes any information derived from their position as directors.

The Listing Rules contain express provisions on confidentiality, especially in relation to the price-sensitive information obtained by the directors of a listed company and impose an absolute prohibition on directors to deal with any of the securities of a listed company at any time when the directors are in possession of unpublished price-sensitive information in relation to those securities.⁸

8. See 'Model Code for Securities Transactions by Directors of Listed Companies', Appendix 10 of the Main Board Rules and 'Securities transactions by directors', Rules 5.54 to 5.60 of the GEM Rules.

[2] General Duties

[a] Skill, Care, and Diligence

Traditionally, a director need not exhibit a greater degree of skill than could reasonably be expected from a person of his or her knowledge and experience. However, developments in the law arising from a series of business failures in the early 1990s have led to the development of a more stringent test. The mixed objective and subjective test at common law is now codified in the Companies Ordinance, which requires directors to exercise reasonable care, skill, and diligence.⁹ 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.

[b] Duty Not to Exceed Powers

Typically, the Articles will give the directors power to manage the business of the company, and to exercise all the powers of the company which are not required to be exercised by the shareholders. If a director acts outside the authority of the company, or outside his or her own authority, then the actions themselves will generally still be binding on the company as against a third party with whom the company is dealing provided that the third party was without notice of the lack of authority. However, as between the director and the company, the director would nonetheless be liable for any loss which the company suffers as a consequence of his or her actions.

[c] Duty to Creditors

Traditionally, directors owed no independent duties to the creditors of the company. However, modern case law suggests that when a company is close to insolvency, or is in fact insolvent, the interests of the company are identified with the interests of its creditors.¹⁰

[B] Who Can Sue?

Since a director's duty is generally owed to the company as a whole, it is the company who should sue the directors. However, there are exceptions where directors may owe a duty to individual shareholders and creditors.

9. Section 465 Companies Ordinance.
10. *Tradepower (Holdings) Ltd (In Liq) v. Tradepower (Hong Kong) Ltd & Ors* (2009) 12 HKCFAR 417 applied the principle in *Kinsela v. Russell Kinsela Pty Ltd* (1986) 10 ACLR 395, where Street CJ's judgment wrote that 'where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets'.

[1] Duties Owed to Individual Shareholder

Directors owe duties by virtue of their office to the company and do not generally owe a duty to shareholders.¹¹ However, this principle has been eroded to some extent so that, particularly in small private and family-owned companies, directors may be found to have assumed duties of a fiduciary nature to individual shareholders.¹²

In relation to large companies or listed companies, directors' duty towards shareholders may arise on a takeover, but such duty is minimal in the sense that they may only owe a duty not to mislead shareholders.¹³

[2] Duties Owed to Creditors

Directors do not generally owe fiduciary duties to the creditors of the company by virtue of their office. However, if a company is insolvent, the liquidator, and in certain circumstances the creditors themselves, may take action against the directors in order to maximize the assets of the company available for distribution. A company's insolvency does not per se give rise to a specific duty owed by the directors to the creditors, but any breach of duty by the directors or failure to consider the interests of the creditors whilst the company was insolvent would be actionable by the liquidator.

In winding-up proceedings, any creditor, shareholder, liquidator, or the Official Receiver may make an application to the court to examine the conduct of directors to compensate the company for any loss resulting from the directors' misfeasance or breach of duty. Although such an action may be brought by a creditor, any recoveries would fall to be distributed to all creditors, not to those who initiated the misfeasance proceedings to the exclusion of others.

[C] Who Can Be Sued?

Directors, shadow directors, or de facto directors are all liable to be sued for wrongs done to the company.

The Companies Ordinance defines 'director' to include any person occupying the position of director (by whatever name called) and a 'shadow director' as a person in accordance with whose directions or instructions the board is accustomed to act (excluding advice given in a professional capacity).¹⁴

11. See *Veron International Ltd v. RCG Holdings Ltd* [2015] HKEC 1432, following *Percival v. Wright* [1902] 2 Ch. 421.

12. Re *Peregrine Investments Holdings Ltd* [1998] 2 HKLRD 670.

13. See *Gething v. Kilner* [1972] 1 All ER 1164; *Goldex Mines Ltd v. Revill* [1974] 54 DLR (3d) 672; and *Dawson International v. Coats Patons Plc* [1988] SLT 854.

14. Section 2 Companies Ordinance.

[D] Derivative Actions

Under the rule in *Foss v. Harbottle*,¹⁵ if a wrong has been inflicted on a company, the proper plaintiff is the company itself. Since directors' duties are owed to the company, an individual shareholder him- or herself cannot bring an action against a director. In practice, the right to determine whether or not the proceedings should be brought lies with the directors, or where applicable, the majority shareholders. This would mean that if the directors resolve against taking legal action, there is little likelihood of the minority shareholders receiving redress.

[1] Common Law Derivative Action

The 'majority rule' supports the principle that the will of the members of the company should, in general, prevail. However, the courts have developed exceptions to the rule in *Foss v. Harbottle* to allow minority shareholders to sue on behalf of the company. The most important exceptions are:

- where there has been 'fraud on the minority'; and
- the wrongdoers are in control of the company in general meeting.

There are, however, certain disincentives associated with the commencement of derivative actions by minority shareholders. First, the shareholder bringing the action risks being liable for costs even though he or she has no corresponding right to the potential damages awarded. Second, shareholders (who are not insiders) are unlikely to be able to gain access to the required information for the purpose of commencing a proper action.

[2] Statutory Derivative Action

The Companies Ordinance¹⁶ provides for shareholders of a company or associated company to bring an action on behalf of the company for misconduct committed against the company where the company fails to do so. Misconduct is defined to mean fraud, negligence, breach of duty, or default in compliance with any law.¹⁷

The shareholder must first obtain leave of the court before bringing a derivative action. The court may grant leave if it is satisfied that the granting of leave is in the interest of the company, that there is a serious question to be tried and the company has not brought proceedings, and the prescribed written notice has been served on the company.¹⁸ These requirements have been repeatedly applied in cases; and it is now established that the threshold for shareholders is relatively low and the court would not

15. [1843] 67 ER 189.

16. At Part 14 Division 4.

17. Section 731 Companies Ordinance.

18. Section 733 Companies Ordinance.

normally look into the merits of the proposed derivative action.¹⁹ There is no requirement under the Hong Kong provisions for the applicant to show that he or she is acting in good faith in seeking to bring the derivative action (unlike some of the overseas provisions).

The courts are now given a very wide discretion to make orders which they think appropriate, including awarding costs to members bringing the action and to order the appointment of an independent person to investigate and report to the court on various matters relating to the company. In addition, the court can also order costs of the appointment of such independent person to be borne by, among others, the company.

[E] Unfair Prejudice

The Companies Ordinance provides another statutory remedy for minority shareholders, particularly in relation to private companies.²⁰ It is an alternative to the ‘just and equitable’ winding-up remedy under the CWUMPO²¹ and entitles a member to make an application to the court for appropriate orders where the member has been unfairly prejudiced or an actual or proposed act or omission would be unfairly prejudicial.

The types of ‘corporate wrongs’ that can give rise to unfair prejudice include:

- payment of excessive remuneration to directors;
- diversions of business of the company;
- use of corporate assets to subsidize businesses of related persons; and
- use of moneys belonging to the company.

In Hong Kong, many listed companies are under the control of the founding family or families, which means that the issues in those companies often revolve around the tension between substantial shareholders and minority shareholders, as is the case with private companies.

The court has discretion to choose from a wide range of remedies, including:

- an order restraining the commission or the continuation of some act;
- an order providing for the majority shareholders or for the company itself to buy the shares of other members;
- an order regulating the affairs of the company in the future.

[F] Representative Actions

Unlike in the United States, class action is non-existent in Hong Kong. Instead, a ‘representative action’ could be brought. This does not give rise to a new cause of

19. See *Re Li Chung Shing Tong (Holdings) Ltd* [2011] 5 HKLRD 274 applying *Re F & S Express Ltd* [2005] 4 HKLRD 743.

20. Part 14 Division 2 Companies Ordinance.

21. Section 177 the CWUMPO.

action or remedy to the aggrieved shareholders against the directors of the company, but provides a procedural convenience for some shareholders to be selected to represent the rest, so that the rights as between all parties may be decided in a suit so constituted. It is not commonly used.

The Law Reform Commission of Hong Kong began work on reforming the class action regime in 2006 and published a *Report on Class Actions* in 2012. We are currently awaiting proposals to introduce a comprehensive class action regime in Hong Kong.

[G] Insolvency Context

Where a company is in financial difficulty, directors may be held personally liable in a number of different ways, both under the statutory provisions and under general law. Statutory claims against directors are for the most part available to the liquidator and in more limited circumstances to a company's creditors.

[1] Misfeasance

If in the course of winding up, the court considers that any past or present officer has misapplied, retained, or become accountable for any money or property of the company or has been guilty of any misfeasance or breach of duty which is actionable by the company, the court may order that person to repay or restore the money or property or otherwise contribute towards the assets of the company by way of compensation.²²

[2] Fraudulent Trading

Where the court considers that the business of a company, if being wound up, has been carried on with intent to defraud creditors, or for any fraudulent purpose, the court may declare that anyone who knowingly carries on the company's business with such fraudulent intent is personally liable for all or any of the debts and other liabilities of the company as the court may direct.²³

The corresponding criminal offence provides for up to five years of imprisonment on indictment and/or a fine (unlimited on indictment) for any person who knowingly carries on the business with fraudulent intent.²⁴ No winding up is necessary for criminal liability to arise.

[3] Disqualification Order

Directors acting in breach of duty may also be disqualified by the court under Part IVA of the CWUMPO. The primary purpose of disqualification is to remove delinquent

22. Section 276 the CWUMPO.

23. Section 275 the CWUMPO.

24. Section 275(3) and Sch. 12 the CWUMPO.

directors from office and general circulation, thereby protecting the public at large from future misconduct by these directors. Contravention of a disqualification order is a criminal offence.

[H] Costs and Fees in Liability Litigations

The general rule is that costs follow the event. In this regard, if a party loses its case in litigation, it would end up paying two sets of legal fees, that is, his or her own and part of the opponents' legal costs. Similarly, a liquidator is potentially exposed to personal liability for costs should the company's action against its directors for misfeasance fail.

III INDEMNIFICATION

The Companies Ordinance now expressly permits the company to indemnify directors for liability to third parties.²⁵

However, the Companies Ordinance renders void any provision purporting to exempt a director from any liability to the company itself.²⁶ The Companies Ordinance also prohibits the company from indemnifying directors for fines and penalties, as well as criminal proceedings, unless the director is acquitted or judgment is given in his favour.²⁷ The Companies Ordinance does permit companies to take out insurance to cover this (see below).

IV PROTECTION AGAINST WRONGS OF DIRECTORS

The courts have moved towards a stringent approach when considering duties owed by directors and are mindful to ensure that directors do not put themselves in a position where their duties and interests conflict. Where there has been a breach, however, there are nonetheless mechanisms to rectify the default and to minimize loss.

[A] Ratification

As a general principle, mere breaches of fiduciary duties such as self-dealing or dealing to the exclusion of the company (as opposed to misapplications of company property), can be ratified by an ordinary resolution of the general meeting after the director has made full and frank disclosure.²⁸ The Companies Ordinance also allows a company to ratify a director's conduct involving negligence, default, breach of duty or breach of

25. Section 469 Companies Ordinance.

26. Section 468 Companies Ordinance.

27. Section 469 Companies Ordinance.

28. *Regal (Hastings) Ltd v. Gulliver* [1942] 1 All ER 378.

trust in relation to the company by unanimous resolution of the disinterested members of the company.²⁹

[B] Directors' and Officers' Liability Insurance

The Companies Ordinance permits a company to take out insurance for a director against any liability to any person in connection certain types of breach and liability. In line with initiatives to strengthen directors' accountability and increased regulatory scrutiny, the demand of directors' and officers' (D&O) liability insurance has increased, as has the level of coverage.

V CORPORATE GOVERNANCE

[A] Existing Corporate Governance

The rewrite of the companies' framework took over six years to complete. One of the four major objectives for the rewrite of the new Companies Ordinance was to enhance corporate governance.

Under the new Companies Ordinance, a 'Responsible Person', (which includes directors) will be liable for a contravention of the Companies Ordinance, without any requirement for knowledge or wilfulness – in contrast to the old regime. This is seen to be potentially increasing the risk for directors and individuals.

The Listing Rules have also been updated and now require the Board of a listed company to have a minimum of three INEDs representing at least one third of the board, an audit committee and a remuneration committees. The Listing Rules also stipulate that the majority of the audit committee members should be INEDs.³⁰

[B] Corporate Governance Reform: Difficulties in Hong Kong

[1] Family-Controlled Companies

Family control is a significant feature of Hong Kong listed companies. Typically, a single extended family owns a significant proportion of the listed company's shares, with the controlling family members or their nominees occupying senior management positions. It is not uncommon for the CEO and chairman to be the same person representing the interests of the controlling family. Given the timeline of development in Hong Kong's history, shareholder disputes are now commonly arising amongst third generations who have inherited interests from companies built up by the business founders.

29. Section 473 Companies Ordinance.

30. Rules 3.10 and 3.21 the Listing Rules.

[2] Quality of INEDs

The corporate governance system introduced in Hong Kong relies heavily on INEDs. These INEDs are said to bring to the company specific expertise, objectivity, and the ability to monitor and assess the Board's performance at the highest level without fear or favour.

Given the relatively small business community and the fact that many companies are family controlled, in reality it is very difficult for Hong Kong to have truly independent INEDs. In practice, INEDs, who are well qualified in terms of business expertise and experience, are usually connected to the company's chairman or managing director.

[C] Going Forward

The development of corporate governance issues in Hong Kong faces challenges different to other jurisdictions owing to the unique Hong Kong business environment.

The codification of the standard of care expected of a director in a company now places greater scrutiny of the duty to understand company's affairs and to be proactive in its management, and the extent of time commitment and attention required to act as a director. Given the trend in Hong Kong for prominent members of the community to sit on the boards of multiple companies, we may see more failures to meet the minimum standard of care by way of negligent omission.

The lack of independence of the Board in some large companies will also continue to expose the minority to unfair prejudice and the effectiveness of legislative initiatives to provide redress remains to be tested.