

Directors and Officers Liabilities in Russia



Further information

If you would like further information on any aspect of the issues described in this note please contact a person mentioned below or the person with whom you usually deal.

Contact

Oxana Balayan

Partner

T +7 495 933 3000

E oxana.balayan@hoganlovells.com

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

Contents

1. PERSONS SUBJECT TO LIABILITY	1
2. PERSONS AUTHORISED TO FILE CLAIMS AGAINST DIRECTORS AND THE GROUNDS FOR SUCH CLAIMS	1
2.1 Company	1
2.2 Shareholders	1
2.3 Creditors and other third parties	2
2.4 Government bodies	2
3. CONDITIONS FOR DETERMINING LIABILITY	2
3.1 Director's guilt	2
3.2 Burden of proof	3
3.3 Court decisions	3
3.4 Limitation period	3
3.5 Foreign law and foreign courts	3
4. TYPES AND EXTENT OF LIABILITY	3
5. COMPANY'S LIABILITIES ARISING OUT OF THE DIRECTORS' ACTIVITY	4
6. PROTECTION AGAINST LIABILITY	4
6.1 Indemnification by the company	4
6.2 Insurance against directors' liability and related risks	4
6.3 Foreign insurance companies and insurance of Russian risks	5

Directors and Officers Liabilities in Russia

This note briefly describes the liability of directors and officers of Russian companies. The general provisions on directors and officers liabilities are laid down by the Civil Code of the Russian Federation and Federal Laws on Joint Stock Companies and Limited Liability Companies respectively.

1. PERSONS SUBJECT TO LIABILITY

1.1 The persons subject to liability in respect of damage caused to a company or its shareholders or third parties are the members of the management bodies of the company. More particularly in joint stock companies and limited liability companies the persons liable are:

- (a) executive bodies (general director and members of the management board); and
- (b) members of the board of directors.

1.2 Instances in which other senior managers of a company (for example, the chief accountant) are exposed to directors' liability are rare.

2. PERSONS AUTHORISED TO FILE CLAIMS AGAINST DIRECTORS AND THE GROUNDS FOR SUCH CLAIMS

Claims against the directors may be filed by:

2.1 Company

The law currently provides the company itself with a broad range of legal options for filing claims against its directors. Claims may be filed by a company on the following grounds:

- (a) for damages caused by breach by the directors of the general principle of good faith and prudence; and
- (b) in respect of any claims filed against the company by the shareholders, creditors or other third parties whose rights are violated. These parties cannot file claims directly against the directors (save for certain cases described in sections 2.2 and 2.3 of this note) but must file claims against the company which may then hold the directors accountable.

In addition to this, while the specific grounds for directors' liability to third parties remain rather limited, claims on behalf of and (or) for the benefit of the company may be filed by a wide range of persons (including shareholders, liquidators, and the company itself represented by other directors authorised to act on behalf of the company or other authorised persons), making this the most likely method for pursuing directors.

The most common basis for a company's claim is its directors' failure to comply with the principle of good faith and prudence.

- (a) The principle of good faith and prudence is set out in legislation and, to a certain extent, is reflected in the current court practice. This principle, *inter alia*, imposes an obligation on the directors to protect and uphold the company's interests, to adhere to the principle of loyalty in his relations with the company and to demonstrate high levels of care and diligence, while at all times complying with the law when conducting the company's affairs. When dealing with matters of directors' liability a clear understanding of the meaning of this principle is of key importance.

The question of whether a director has abused corporate funds is one issue decided on the basis of the principle of good faith and prudence. A typical area of concern is the breach of the approval procedure for company transactions in which a director is interested.

- (b) Directors' duties are explicitly set out by law. Special requirements are applied, for example, to a company's corporate governance, the issue of securities and the entering into major and interested party transactions. In most cases, directors' duties cannot be delegated to other bodies (persons). However, the extent of directors' duties may be widened by agreement and/or by amending the company's charter.

Russian law also provides for certain grounds for directors' liability in specific circumstances.

- (a) The Federal Law on Bankruptcy (Insolvency) (the "**Bankruptcy Law**") imposes liability on directors for damages caused by a breach of its provisions.
- (b) A director who, in accordance with the Russian company law, is or represents an interested party in an interested party transaction is responsible for informing the company and its relevant bodies about this. Failure to do so will render the director liable for any damages caused by the non-disclosure of this fact.

2.2 Shareholders

- (a) Shareholders holding over 1% of shares in a joint stock company and any participants of a limited liability company may file a claim

at court for the compensation of any damage caused to the company by such company's directors. There are no obstacles (such as the requirement for a decision of the board of directors or a special committee) which could prevent a shareholder or participant from applying to court. Such a claim could be brought on the grounds of the director's breach of the principle of good faith and prudence with respect to the company. Any damages awarded are to be paid directly to the company.

- (b) Shareholders may file suits directly against the directors for compensation for damage caused to the company or the shareholders by a director's actions in violation of the special provisions relating to the purchase of shares in an open joint stock company as set out by the Federal Law on Joint-Stock Companies.
- (c) In addition, there are a limited number of other cases in which a company's shareholders may file suits directly against the directors. These include cases where a director:
 - (i) breaches a company's corporate governance rules which cannot be attributed to the company's actions (for example, in case of a criminal or administrative law violation committed by the director); or
 - (ii) breaches a special legal provision which imposes liability on the director (for example, breaches the provisions of the Bankruptcy Law, in which case the director shall be liable for the damages caused to the shareholders as a result of such breach).

2.3 Creditors and other third parties

Creditors and other third parties have the right to file claims directly against a company's directors in a limited number of cases, most of which are connected with the insolvency of the company and the issuance of securities. Directors are liable to the creditors in the following instances:

- (a) The general director fails to file an application for insolvency at a court within the one month period following the occurrence of an event triggering the insolvency of the company as defined by

the Bankruptcy Law. The general director may be held liable to the creditors of the company for the losses incurred after the expiration of the one month period.

- (b) The directors breach other specific provisions established by the Bankruptcy Law. For example, directors may be held liable if the company's financial statements are missing at the time the court finds the company insolvent or an application for insolvency was filed by the company where the company was able to satisfy all the creditors' claims and the insolvency application caused damages. In these cases, the directors are obliged to reimburse the creditors of the company for any damage caused.
- (c) The offering circular issued with regard to the company's securities contains incorrect or misleading information. The directors will be jointly and severally liable for the damages caused to investors where the offering circular has been signed by the directors.

2.4 Government bodies

Government bodies acting in capacity of a company's shareholder or creditor do not enjoy any privileges and generally have equal rights with other shareholders and creditors including those in relation to directors' liability. Relevant authorities also enjoy the exclusive right to impose criminal and administrative liabilities on directors pursuant to the Criminal Code and the Administrative Offences Code. The most common offences for which a company's director may be held liable for are tax evasion, fraud, running business without the required licences and permits, as the case may be etc.

3. CONDITIONS FOR DETERMINING LIABILITY

3.1 Director's guilt

- (a) As a general rule, a director will be held liable for inflicting damage in cases where guilt can be established.
- (b) A director's guilt in case of liability to the company remains to be clearly determined. However, the general approach is that the objective criterion of guilt is applicable to directors in such cases. This means that, in order to establish guilt, it is necessary to prove as a matter of fact the breach of the principle of good faith and prudence.

(c) A director should not be found guilty and liable for damages caused to the company if his decisions or actions do not breach the principle of good faith and prudence – an incorrect business decision does not establish guilt and is not a ground for liability. However, in contrast to the legal concepts applied in other jurisdictions, the Russian courts:

- (i) have the right to analyse the essence of a business decision having regard to all circumstances in which it was taken; and
- (ii) are not authorised to lower the criteria by which the directors' actions should be judged (for example, the requirement of "reasonableness" may not be reduced to the lower standard of "rationality"). When determining the grounds and the extent of a director's liability, the court should take into consideration usual business practice and other similar factors.

3.2 Burden of proof

Where a director breaches the general principle or a specific law, damage and causation should normally be proved by the person filing a claim against the director. Once damage and causation have been proved, the Civil Code states that the burden of proof with respect to guilt lies with the accused. Therefore, if the claimant proves the director's violation of the principle of good faith and prudence, damage and causation, the onus is then on the director to prove that he is not guilty.

3.3 Court decisions

(a) Under Russian law, a director will be held liable from the moment that a court ruling against him takes effect. If the director admits his guilt without court proceedings, the payment of compensation to the company or to third parties by the director is possible but it should be noted that the extrajudicial settlement of damages does not ensure the effective protection of the director as there is no legal mechanism in Russian law for excluding future claims from being brought on the same grounds.

(b) Amicable agreements are permitted within the framework of legal proceedings. Although such settlements are subject to court approval, the amount of compensation to be paid is left to the parties' discretion. This process enables the director to pay compensation without admitting his guilt and also prevents any future claims from being brought on the same grounds.

3.4 Limitation period

The limitation period during which a director is liable is generally three years from the decision or action in question. The court may waive this limitation if the claim is filed by a natural person who missed the limitation period for a good reason (for example, serious illness or disability).

3.5 Foreign law and foreign courts

(a) In accordance with Russian provisions on conflict of laws, substantive foreign law can be applied to actions connected to directors' liability to third parties in cases where the grounds for compensation for damages have arisen in a foreign state. In such instances, the claim will go before a court in the jurisdiction where liability arose and this foreign court will determine the applicable law in accordance with its own national legislation on conflict of laws.

(b) A foreign decision may be enforced in Russia on the basis of bilateral international treaties. Although these bilateral treaties exist between Russia and certain countries, such treaties have yet to be signed with the majority of those countries which are most relevant from the point of view of directors' liability in Russia (for example, the USA, the UK, Germany, France and Japan).

4. TYPES AND EXTENT OF LIABILITY

4.1 Under Russian law the only measure against directors' found liable is compensation for damages caused to the company, its shareholders or third parties. The maximum amount of damages cannot be limited by a pre-engaged agreement, but any agreed figure may be reduced by the court taking into account the circumstances of the case. In certain special instances (for example those of liability relating to a company's insolvency or the issue of securities mentioned above) the director bears third-party liability for the company's debts. As a rule such liability is secondary, arising only where the company's funds are insufficient to cover the

compensation payments, although in certain situations there is also direct liability which arises notwithstanding the company's funds. The imposition of penalties (analogous with punitive damages) is not possible except where agreed between the director and the third party (after the damage is caused).

- 4.2 Liability is joint and several where two or more directors jointly commit a tort. This means that the company or a shareholder or a third party can claim all the damages from any one of the directors liable for the damages. Such director may then file recourse claims against the other jointly liable directors for a proportional contribution to the compensation amount.

5. COMPANY'S LIABILITIES ARISING OUT OF THE DIRECTORS' ACTIVITY

The company bears direct liability to any third parties and shareholders in connection with the directors' actions, unless otherwise provided by legislation (although, as already mentioned, this is rare). In particular, the company is liable to shareholders for the violation of most of the responsibilities imposed on directors in respect of corporate governance. If a company has borne third-party liability for its directors' actions or omissions which violated the principle of good faith and prudence, the company is entitled to file a recourse claim against the directors for losses incurred.

In terms of criminal law, legal entities operating in Russia are not subject to criminal liability and it is only its directors that may be held liable for offences committed by them in this capacity or the company itself.

6. PROTECTION AGAINST LIABILITY

6.1 Indemnification by the company

- (a) Indemnification by the company of expenses arising from a director being held liable to the company (including when being held liable for suits brought by shareholders / participants for the benefit of the company) is illegal insofar as it may be considered to be a pre-arranged limitation of the directors' liability.
- (b) Indemnification by the company of expenses arising from a director being held liable to third parties is possible in principle. However, this principle is not applicable where a breach of third-party rights by the director occurs concurrently with a breach of the principle of good faith and prudence with respect to the company. In addition, there is

a risk that a court will invalidate indemnification transactions that are entered into prior to such liability arising.

- (c) Indemnification by the company for expenses incurred by a director is possible on the basis of extrajudicial or amicable settlements. Where a director is not found liable by a court, the company may pay all costs and expenses related to the proceedings. However, there is a risk that indemnification transactions that are entered into before the respective extrajudicial or amicable settlement is agreed may be held invalid.

6.2 Insurance against directors' liability and related risks

- (a) Insurance against directors' liability to third parties
- Insurance against such liability is permitted as long as it does not insure against liability arising from an illegal act (for example, criminal liability, administrative liability and civil claims connected with criminal liability).
- (b) Insurance against directors' liability to the company
- Insurance against the liability of directors to the company is permissible on the basis of the rules for non-contractual liability insurance. The risk of invalidation of such insurance as a result of the rules for contractual liability insurance being applied, although theoretically possible, is low.
- (c) Insurance against the effect on the company of a transaction completed by a director outside of his powers
- It has not yet been confirmed in practice whether it is permissible to insure against such risk. There is little court practice which holds a company liable where its directors acted in an excess of powers.
- (d) Insurance against the risk of directors losing property on an extrajudicial settlement of claims or an amicable agreement
- The ability to insure is uncertain in cases where liability has been admitted by a director extra judicially, an amicable agreement concluded or an extrajudicial agreement on compensation with no admission of liability entered into. In this case admission of liability, mutual

settlement or agreement on compensation may contradict the Russian concept of insured event which is traditionally seen as an event out of the sphere of influence of the insured person.

- (e) Insurance for the company in connection with the directors' actions

Insurance of the company's third-party liability for damage inflicted by directors' actions (omissions) is possible (subject to certain limitations) and, given the conditions in which business is sometimes conducted in Russia it is generally advisable. However there is a lack of clarity as to whether a company can take out insurance in respect of expenses arising from indemnification payments made to directors in connection with their liability.

6.3 **Foreign insurance companies and insurance of Russian risks**

- (a) As a general rule, foreign insurance companies, their affiliates and representative offices may not carry out insurance activities in Russia. Russian subsidiaries of foreign insurers may operate on the Russian market but are subject to certain restrictions.
- (b) The risks against which companies resident in Russia may wish to insure should be insured with Russian insurers (or Russian subsidiaries of foreign insurance companies). However, where the person whose rights have been breached is a foreign person and certain other criteria are met, it may be possible to take out insurance for compensation due in respect of such a breach with a foreign insurance company.

May 2011

www.hoganlovells.com

Hogan Lovells has offices in:

Alicante	Chicago	Hong Kong	Munich	Shanghai
Amsterdam	Colorado Springs	Houston	New York	Silicon Valley
Baltimore	Denver	Jeddah*	Northern Virginia	Singapore
Beijing	Dubai	London	Paris	Tokyo
Berlin	Dusseldorf	Los Angeles	Philadelphia	Warsaw
Boulder	Frankfurt	Madrid	Prague	Washington DC
Brussels	Hamburg	Miami	Riyadh*	Zagreb*
Budapest*	Hanoi	Milan	Rome	
Caracas	Ho Chi Minh City	Moscow	San Francisco	

"Hogan Lovells" or the "firm" refers to the international legal practice comprising Hogan Lovells International LLP, Hogan Lovells US LLP, Hogan Lovells Worldwide Group (a Swiss Verein), and their affiliated businesses, each of which is a separate legal entity. Hogan Lovells International LLP is a limited liability partnership registered in England and Wales with registered number OC323639. Registered office and principal place of business: Atlantic House, Holborn Viaduct, London EC1A 2FG. Hogan Lovells US LLP is a limited liability partnership registered in the District of Columbia.

The word "partner" is used to refer to a member of Hogan Lovells International LLP or a partner of Hogan Lovells US LLP, or an employee or consultant with equivalent standing and qualifications, and to a partner, member, employee or consultant in any of their affiliated businesses who has equivalent standing. Rankings and quotes from legal directories and other sources may refer to the former firms of Hogan & Hartson LLP and Lovells LLP. Where case studies are included, results achieved do not guarantee similar outcomes for other clients. New York State Notice: Attorney Advertising.

© Copyright Hogan Lovells 2010. All rights reserved.

Associated offices