

# Claims for Damages against Company Directors: Summary Review for 2018 and the First Six Months of 2019

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The international law firm Debevoise & Plimpton LLP presents a new review of the court practice of circuit *arbitrazh* courts and the Supreme Court of the Russian Federation (the “courts”) on claims against members of company management bodies (“directors”) for damages caused to the directors’ companies by their actions.

We have analysed the court practice for the period of 1 January 2018 to 30 June 2019 and reviewed a total of approximately 220 judgements rendered over that period. Please note that this review does not consider any cases related to secondary liability of directors, including bankruptcy cases, or liability of controlling persons in bankruptcy cases.

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## Number of Successful Claims against Directors Is on the Rise

As we pointed out in our previous review,<sup>1</sup> since the beginning of 2014, the number of claims against directors for damages caused to their companies by their actions had been consistently increasing. However, in 2017 and 2018, we saw a reverse trend: the number of such claims against directors began to drop. While in 2016, the courts considered 267 such claims, in 2017, it was 176 claims, and in 2018, 166 claims. In the first six months of 2019, the courts considered 54 claims against directors, which is more than in 2018 (in the first six months of 2018, the courts considered 39 such claims).

However, despite the reduction of the total number of claims, the percentage of successful claims has increased compared to 2016. While in 2016, 46% of claims were successful (122 out of 267), in 2017, it was 51% of claims (90 claims out of 176), and in 2018, 58% of claims (96 claims out of 166). In the first six months of 2019, 54% of claims were successful (29 claims out of 54), which is higher than the percentage of successful claims for the first six months of 2018 (49% (19 claims out of 39)).

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<sup>1</sup> See our Client Update *Claims for Damages against Company Directors: Summary Review for 2016 and the First Six Months of 2017* dated 25 October 2017 available [here](#).

The amount recovered where claims are successful has also increased. In 2016, the average amount recovered was RUB 29,022,986 (with the largest recovery being RUB 884,947,369.68<sup>2</sup>). In 2017, it somewhat decreased to RUB 13,075,820 (with the largest recovery being RUB 170,970,369<sup>3</sup>), but in 2018, it grew again to RUB 29,249,991 (with the largest recovery being RUB 751,290,893<sup>4</sup>). In the first six months of 2019, the average amount recovered was RUB 14,230,408, and the maximum amount recovered was RUB 99,781,908.94.<sup>5</sup>

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## Board Members Also Held Liable

The majority of claims is still filed against the executive bodies of a company, especially its chief executive officer. However, as in previous periods, certain claims are made against the board members as well. In 2017, 5 such claims were filed (2 successful and 3 dismissed), and in 2018, there was one such claim (dismissed). For the first six months of 2019, one claim against board members was filed and it was not successful.

In 2018, the amount of claims against board members was RUB 1,081,200, and in the first six months of 2019, RUB 7,000,000. When the claims against board members were dismissed, it was held that taking a disputed decision the board had acted within its powers and authority or that the board had acted reasonably and in good faith in performing their duties.

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## The Courts Continue to Focus on Acting in Bad Faith

As in 2016 and 2017, the majority of claims upheld by the courts in 2018 and the first six months of 2019 related to the members of executive bodies acting in bad faith, including:

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- <sup>2</sup> Ruling of *Arbitrazh* Court of the Moscow Circuit dated 22 April 2016 in Case No. A40-57914/2012 – the company's CEO caused losses to the company by knowingly acquiring illiquid promissory notes on its behalf.
  - <sup>3</sup> Ruling of *Arbitrazh* Court of the Urals Circuit dated 9 June 2017 in Case No. A60-39951/2014 – upon the termination of an assignment agreement, the company's CEO took no action to recover the funds paid by the company for the assigned rights.
  - <sup>4</sup> Ruling of *Arbitrazh* Court of the Central Circuit dated 7 August 2018 in Case No. A36-3351/2013 – members of the bank's management bodies acted in breach of the regulations of the Bank of Russia and failed to exercise due care and diligence when evaluating borrowers, which resulted in the extension of loans to persons incapable of fulfilling their obligations, and these members also knowingly entered into a number of transactions on terms unfavourable for the bank.
  - <sup>5</sup> Ruling of *Arbitrazh* Court of the Moscow Circuit dated 24 April 2019 in Case No. A40-25395/2016 – the company's CEO executed transactions with entities showing evidence of being shell companies without any consideration paid by them and contrary to normal business practices.

- knowingly transferring the company's funds to insolvent counterparties, including as a result of commercial operations with shell companies;
- unreasonable spending of the company's funds, including by transferring funds to a personal account or to third parties, paying unreasonable bonuses or spending without providing support documents;
- receiving funds from the company's counterparties payable to the company and misappropriating such funds;
- stripping assets, including by their alienation to the director's affiliates at an undervalue;
- knowingly executing transactions on unfavourable terms, including for the sale of property at an undervalue, including pursuant to an interested party transaction;
- transferring the company's funds without consideration;
- failing to transfer documents and assets of the company to the receiver;
- engaging in unlawful behaviour whereby the company was held liable for tax offences (e.g., late payment of taxes, failure to provide documents to the tax authority or organising a tax evasion scheme) or administrative offences (e.g., as a result of breach of corporate or labour legislation);
- failing to fulfil duties imposed on the company by law (e.g., to pay salary to the company employees);
- receiving unreasonable payments from the company, including excessive salary, bonuses or benefits;
- engaging in competing business with improper use of the company resources;
- executing a transaction exceeding the authority of director.

However, in 2018 and the first six months of 2019, the courts upheld a number of claims involving unreasonable acts or omissions of members of the executive bodies, including:

- failure to establish a proper accounting and control system in the company;
- delayed exercise of the company's rights or protection of its interests, including due to the expiration of the statute of limitations;

- improper screening of counterparties leading to the execution of an agreement with a demonstrably insolvent entity;
- lack of control over the use of IP by the company resulting in civil liability of the company for its illegitimate use.

The courts dismissed claims against directors where it was found that the unlawful misconduct, damages and their amount or the causal link between the behaviour of the members of executive bodies and the damages had not been shown, that the claim had been made against an improper respondent (e.g., against a company member or a person who had not acted in the capacity of an executive body over the disputed period), that the limitation period had expired, that the members of the executive bodies had acted within the scope of risks assumed in the ordinary course of business or that the claimant had abused its rights (e.g., an action had been brought in a situation of a corporate conflict to injure one of the involved parties).

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## Notable Cases Decided in 2018 and the First Six Months of 2019

### **The General Director Failed to Arrange for Recordkeeping in Respect of Company Assets and Inventory<sup>6</sup>**

A trading company lacked a proper system of accounting and safe-keeping of goods and assets – the primary documents were drawn incorrectly (specifically, the documents for the receipt and shipment of goods were signed by persons who were not effectively involved in such operations), the system of pecuniary liability was not in place (specifically, a responsible employee bearing pecuniary liability was not appointed and no pecuniary liability agreements were made with the employees involved in the receipt and shipment of goods). The lack of proper control over the goods and assets of the company resulted in a shortage revealed in the course of stocktaking. The damages of RUB 26,661,514.50 caused by the shortage to the company were recovered from its General Director.

The court agreed with the findings of the lower courts that the shortage had been a direct consequence of improper performance by the General Director of his duties as general manager since he had failed to ensure the safekeeping of the goods and assets entrusted to him. The court also noted that the company director must make all efforts that are necessary and sufficient to achieve the best possible result of the economic activity of the company and properly perform the duties imposed on him/her by applicable law.

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<sup>6</sup> Ruling of *Arbitrazh* Court of the Urals Circuit dated 5 December 2018 in Case No. A60-70464/2017.

### **The Executive Officers of the Company Failed to Apply for the Repayment of Overpaid Taxes, VAT Refund and Recovery of Accounts Receivable<sup>7</sup>**

The General Directors who managed the operations of the company over the disputed period were ordered to pay RUB 9,327,390.87 in damages caused to the company as a result of failure to request repayment of overpaid taxes and VAT refund and to recover accounts receivable. At the time of filing the claim the company was in bankruptcy proceedings.

In upholding the claim, the court noted that if the company had such entitlements the exercise of such entitlements was in its interests and the exercise thereof was a duty of the company director rather than a right. Therefore, failing to act the former General Directors had breached their duty to act reasonably and in good faith in the interests of the company.

### **The General Director Failed to Act Being Aware of the Breach of Third-Party Exclusive Rights by the Company<sup>8</sup>**

In violation of the exclusive rights of the copyright holder, the Company widely used modified software in its operations. The copyright holder brought proceedings against the company and the company was ordered to pay a compensation for the breach of copyright. The respective losses of RUB 2,696,000 were recovered from the General Director of the company.

The court found that the director had breached his duties as he had known about the unlawful use of the software by the company but had failed to act and, therefore, had failed to exercise control over the use of third party intellectual property by the company.

### **The General Director Failed to Either Contest or Pay the Administrative Penalty Imposed on the Company<sup>9</sup>**

As a result of breach of antitrust law the company was held liable for an administrative offence. The General Director failed to either contest, seek to reduce or timely pay the administrative penalty imposed on the company. This led to the imposition on the company of a fine twice the amount of the unpaid penalty. The respective losses of RUB 1,100,000 were recovered from the General Director.

In upholding the claim the court noted that as expressly stated in the law the General Director had been required to have taken all steps necessary and sufficient to properly

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<sup>7</sup> Ruling of *Arbitrazh* Court of the Moscow Circuit dated 22 February 2018 in case No. A40-117973/2014.

<sup>8</sup> Ruling of *Arbitrazh* Court of the North-Western Circuit dated 27 September 2018 in case No. A42-5390/2017.

<sup>9</sup> Ruling of *Arbitrazh* Court of the East-Siberian Circuit dated 1 October 2018 in case No. A10-3242/2015.

perform the public duties imposed on the company, and in this case, the General Director had not provided any evidence that he had not known about the legal entity being held liable for an administrative offence.

### **The Sole Member of the Company Acting as Its General Director Cannot Cause Damages to Herself<sup>10</sup>**

The company brought proceedings against its former General Director who had also been the sole member of the company but had sold her interest in the charter capital later to a third party for damages caused by unreasonable transfer of funds from the company account to her personal account and withdrawal of cash using the corporate credit card.

The court dismissed the claim holding that the respondent's behaviour had been lawful. Over the disputed period, all cash operations were performed at the behest of the sole member of the company, therefore, her interests could not have been contrary to the interests of the company, i.e., essentially to those of her own. However, after the alienation of the interest in the charter capital no cash operations were performed by the respondent.

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We will continue to provide further updates in respect of new prominent cases and legal positions related to liability of directors. For example, one of the latest noteworthy judgements is Ruling No. 305-ES19-8975 of the Supreme Court of the Russian Federation dated 17 September 2019 in Case No. A40-5992/2018. The Supreme Court upheld the position of the Higher *Arbitrazh* Court that fulfilment of instructions of the general meeting of participants or approval of the actions taken by the director by the general meeting of participants will not relieve such director from liability if losses have been caused to the company by his behaviour. The court also emphasised that the director may not follow the instructions of the general meeting of participants if it is harmful to the interests of the company. The director may not rely on acting pursuant to such instructions as it is one of his duties to determine whether certain actions and their consequences will be beneficial for the company.

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Please do not hesitate to contact us with any questions.

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<sup>10</sup> Ruling of *Arbitrazh* Court of the Moscow Circuit dated 14 June 2019 in case No. A40-222643/2018.

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