

# Client Update

## Claims for Damages Against Company Directors: Summary Review for 2016 and the First Six Months of 2017

The international law firm Debevoise & Plimpton LLP presents a new survey of the court practice of the circuit *arbitrazh* courts and the Supreme Court of the Russian Federation<sup>1</sup> (the “courts”) on claims against members of company management bodies (“directors”) for damages caused to the directors’ companies by their actions.

We have analyzed the court practice for the period from 1 January 2016 to 1 July 2017 and reviewed a total of approximately 400 judgements rendered over that period.

### NUMBER OF SUCCESSFUL CLAIMS AGAINST DIRECTORS REMAINS HIGH

Since the beginning of 2014, the number of claims against directors for damages caused to their companies by their actions has been consistently increasing. In 2014, the courts considered 151 claims; in 2015, 194 claims; and in 2016, 267 claims. Consequently, 2016 saw a 1.4 increase in the number of claims considered by the courts compared to 2015 and an 1.8 increase compared to 2014. In the first six months of 2017, the courts considered 125 claims against directors.

Almost 50% of the claims during these years have been successful.

| Year                  | Total Number of Claims | Number of Successful Claims |
|-----------------------|------------------------|-----------------------------|
| 2014                  | 151                    | 51% (77 claims)             |
| 2015                  | 194                    | 55% (106 claims)            |
| 2016                  | 267                    | 46% (122 claims)            |
| First six months 2017 | 125                    | 44% (55 claims)             |

<sup>1</sup> Prior to 6 August 2014, the Higher *Arbitrazh* Court of the Russian Federation.

The amount recovered where claims are successful has also increased. In 2014, the maximum amount recovered was RUB 223,667,595 (approx. USD 3,856,338<sup>2</sup>);<sup>3</sup> in 2015, the largest recovery decreased to RUB 77,176,862.69 (approx. USD 1,330,636);<sup>4</sup> and in 2016, it increased to RUB 884,947,369.68 (approx. USD 15,257,713).<sup>5</sup> In the first six months of 2017, the maximum amount recovered was RUB 170,970,369 (approx. USD 2,947,765).<sup>6</sup>

### **BOARD MEMBERS ALSO HELD LIABLE**

Despite the majority of claims being filed against the chief executive officer of a company, the number of claims against board members is also rising. In 2014, the only such claim that was filed was dismissed, in 2015, there were two claims (one successful and one dismissed); and in 2016, the courts considered nine such claims (seven claims were dismissed and two claims were successful). The maximum amount recovered under the successful claims against board members in 2016 was USD 12,837,551.29.<sup>7</sup> For the first six months of 2017, four claims against board members were filed, with one claim being successful and three claims being dismissed. The amount recovered under the successful claim was RUB 16,970,959.61 (approx. USD 292,603).<sup>8</sup>

In 2016 and the first six months of 2017, the successful claims against board members involved unreasonable bonuses paid to the chief executive officer or the execution of transactions on terms unfavourable for the company. The courts dismissed claims against board members where the plaintiffs failed to demonstrate that the board members acted in bad faith or unreasonably or to prove that the company suffered damages and that actions of such board members caused such damages. Some claims were also dismissed due to the expiration of the relevant limitation period.

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<sup>2</sup> 1 USD = RUB 58.

<sup>3</sup> The company's CEO sold the same residential property twice in violation of an investment contract; as a result the company had to pay penalties to its counterparty.

<sup>4</sup> The company's CEO transferred the company's funds to shell companies.

<sup>5</sup> The company's CEO caused losses to the company by knowingly acquiring illiquid promissory notes on its behalf.

<sup>6</sup> 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>7</sup> The company's board members approved an assignment of claims nominated in U.S. dollars at a price lower than the nominal price.

<sup>8</sup> The company's CEO and a board member arranged for a series of related transactions for the alienation of immovable property owned by the company, resulting in damages to the company in the form of lost rental income.

## THE COURTS CONTINUE TO FOCUS ON ACTING IN BAD FAITH

The majority of the claims upheld by the courts in 2016 and the first six months of 2017 related to the chief executive officer acting in bad faith, specifically:

- failing to perform the obligations imposed on the company by applicable law (e.g., corporate legislation, securities legislation, tax legislation, etc.) whereby the company was held liable for administrative offenses or suffered other losses (e.g., it had to pay interest);
- making unreasonable payments to himself/herself or other persons pursuant to employment contracts;
- misappropriating the company's funds;
- executing transactions that involved a conflict of interest or competition with the company (soliciting customers, using the company's employees for his/her own business, etc.);
- executing transactions with shell companies or transferring funds to counterparties without consideration;
- alienating the company's assets without proper reason or at a price much lower than the market price;
- knowingly executing a transaction that was unfavourable for the company;
- failing to fulfil duties imposed on the chief executive officer by bankruptcy legislation (e.g., to transfer documents and/or assets of the company to the receiver); and
- transferring assets out of the company prior to its bankruptcy.

In addition to claims related to the bad faith of the chief executive officer, the courts also upheld claims involving the unreasonable actions of the chief executive officer, specifically:

- making decisions without taking into account all of the information available to the chief executive officer;
- unreasonable spending of the company's funds;
- failing to obtain the information required for proper decision making, including failing to conduct due diligence in respect of a counterparty or acquired property;
- failing to establish a proper management system in a company;
- failing to take all necessary actions to exercise control over the performance of obligations by a counterparty under a contract; and
- failing to properly document the transactions of the company and reflect them in the books.

The courts dismissed claims against the chief executive officer where the plaintiffs failed to show unreasonable actions or bad faith of the chief executive officer or to prove that the

company suffered damages and that actions of the chief executive officer caused such damages. The courts also dismissed claims for damages if the chief executive officer acted within the scope of risks assumed in the ordinary course of business. Another reason for dismissal was the expiration of the relevant limitation period.

## **NOTABLE CASES DECIDED IN 2016 AND THE FIRST SIX MONTHS OF 2017**

The notable examples of misconduct that were found to result in liability are the following:

### **Lack of Proper Control over Company's Employees**

A CEO was ordered to pay RUB 254,511,160 (approx. USD 4,388,123) in damages caused to the company due to the improper fulfilment of the duty to organise internal controls in the company. The chief accountant and an accountant of the company performed a number of fraudulent operations with a view to misappropriating the company's funds, as established by the verdict handed down by the court in respect of the chief accountant and the accountant. These operations were conducted using the CEO's digital signature.

The court stated that the CEO failed to arrange for proper accounting practices within the company and failed to exercise control over the actions of the accounting personnel. The court found that the CEO in fact gave up control over the lawfulness of financial operations conducted by the company and delegated his digital signature, giving the right of first signature on financial documents to the accounting personnel and enabling them to misappropriate the company's funds. If the CEO had applied reasonable control over the financial and commercial activities of the company in the ordinary course of business he would have discovered the fraud, which would have prevented adverse consequences for the company. This case also demonstrated that a CEO may be held liable for the entire amount of any losses suffered by the company, not only own misconduct, but also for the unlawful acts of other employees if the company does not have proper internal controls.

### **Improper Creditworthiness Assessment of Company's Counterparties**

The chairman of the management board of a bank and a member of the management board acting as the chief accountant were ordered to pay jointly and severally RUB 59,998,321.16 (approx. USD 1,034,454) of losses suffered by the bank due to extending loans to insolvent borrowers who could not repay them. The chairman of the management board of the bank and the member of the management board were members of the credit committee that approved the extension of loans to several companies. Despite the fact that the chairman of the management board voted against the extension of loans, she signed unsecured facility agreements with the borrowers. The borrowers did not meet the criteria of operating companies and were not able to repay the loans at the time the facility agreements were executed. All attempts to recover the loans failed.

The court found that these adverse consequences could have been avoided if the chairman of the management board and the member of the management board had ensured that they had obtained and verified full and accurate information about the borrowers. If they had properly assessed the creditworthiness of the borrowers, they would not have approved the extension of the loans. This case also demonstrated that even a director who votes against a resolution detrimental to the company may nevertheless be held liable if he/she could have prevented the losses but failed to do so.

### **Breach of Obligations of the Company**

The CEO of a company was ordered to pay RUB 260,854.61 (approx. USD 4,497) of losses (interest paid by the company). The general participants' meeting adopted a resolution to pay the actual value of a deceased member's participatory interest in the company to his heir. Nevertheless, the CEO of the company failed to act or take any steps to implement the resolution of the general participants' meeting. As a result, the company suffered losses as it had to pay interest after the heir recovered the actual value of the participatory interest from the company pursuant to a court order.

### **Failure to Act to Protect the Interests of the Company**

The CEO was ordered to pay RUB 3,810,411.03 (approx. USD 65,697) of losses suffered by the company due to the inability to enforce the collection of debts from one of the company's debtors. The CEO did not apply to a court to collect the debts until after the expiration of the limitation period, and as a result the court order was not granted. The court found that the CEO's failure to act to recover the debts prior to the expiration of the limitation period constituted an unreasonable action contrary to the interests of the company.

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Please do not hesitate to contact us with any questions.

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