Российско -
Американское
Судейское
Партнерство

MATERIALS

BANKRUPTCY AND CORPORATE LAW

Moscow, Russia
April 13 - 15, 1999

NATIONAL JUDICIAL COLLEGE

SUPREME COMMERCIAL COURT OF THE RUSSIAN FEDERATION

Sponsored by United States Agency for International Development (USAID)

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RUSSIA COMMERCIAL COURT WORKSHOP
RUSSIAN-AMERICAN JUDICIAL PARTNERSHIP
(RAJP)

Moscow, Russia
April 13 -15, 1999
Sponsored by USAID

DAY 1
Tuesday, April 13

9 30 am	Registration
10 00 am	**<u>Welcomes and Opening Remarks</u>** **A Arifulin, Vice-Chairman of the Supreme Commercial Court of the Russian Federation** **Judge Betty Barteau, Chief of Party, RAJP**
10 30 am	**<u>Various Aspects of Applying Joint Stock Companies Law</u>** **Presentation by G Shapkina, judge of the Supreme Commercial Court of the Russian Federation**
11 15 am	Coffee break
11 30 am	**<u>Questions and Answers</u>**
11 50 am	**<u>The Defining Tension in Corporate Governance in America</u>** **Presentation by Justice Joseph T Walsh, Supreme Court of Delaware**
12 30 pm	**<u>Questions and Answers</u>**
1 00 pm	Lunch
2 00 pm	**<u>Corporate Criminal Liability in the United States</u>** **Presentation by Justice Joseph T Walsh, Supreme Court of Delaware**
2 30 pm	**<u>Questions and Answers/Panel Discussion</u>**
3 30	Adjourn

DAY 2
Wednesday, April 14

9 30 am	**<u>Application of United States Bankruptcy Law</u>** **Presentation by Judge Sidney Brooks, United States Bankruptcy Court**
10 10	**<u>Questions and Answers</u>**
10 20	**<u>Bankruptcy Trusteeship</u>** **Presentation by Judge Sidney Brooks, United States Bankruptcy Court**
11 00 am	Coffee Break
11 15 am	**<u>Comparative Analysis of the Bankruptcy Procedures in Russia, USA, UK and France</u>** **Presentation by V Stepanov, Doctor of Law**
12 00 pm	**<u>Federal Law "On Insolvency (Bankruptcy)"</u>** **Presentation by A Guznov, Deputy Director of the Judicial Department, Head of the Board for Legal Support of the Central Bank of the Russian Federation**
12 45 pm	**<u>Questions and Answers</u>**
1 00 pm	Lunch
2 00 pm	**<u>Bankruptcy Issues and Draft Regulations of the State Duma</u>** **Presentation by P Bunich, Chairman of the Committee on Property and Privatisation and Economic Activity of the State Duma**
2 40 pm	**<u>Questions and Answers</u>**
2 50 pm	**<u>Trustees</u>** **Presentation by V Golubev, Chairman of the Council of Independent Experts and Reorganisation Trustees, member of the European and World Association of Insolvency Experts**
3 20 pm	**<u>Questions and Answers/Panel Discussion</u>**
3 40 pm	Adjourn

DAY 3
Thursday, April 15

9 30 am	<u>**Issues Related to Labour Law While Applying Bankruptcy Procedures**</u> **Presentation by A Kurennoy, Professor of the Academy of Economy under the Government of the Russian Federation**
10 20 am	<u>**Application of Bankruptcy Law**</u> **Presentation by V Vitryansky, Vice-Chairman of the Supreme Commercial Court of the Russian Federation**
11 00 am	<u>**Questions and Answers/Panel Discussion**</u>
11 50 am	Coffee break
11 30 am	<u>**Economic and Financial Aspects of Restoring Solvency Expert Evaluation of Debtor's Financial Condition**</u> **Presentation by T Prudnikova, Doctor of Economy, scientific secretary of the Scientific Council of the Russian Society of Independent Experts**
12 00 pm	<u>**Questions and Answers**</u>
12 15	<u>**Procedural Issues in the Bankruptcy Law**</u> **Presentation by N Livshits, chief consultant of the Board on Improving Legislation of the SCC**
12 40 pm	<u>**Bankruptcy Trusteeship and Outside Management**</u> **Presentation by O Nikitina, chief consultant of the Board on Improving Legislation of the SCC**
1 00 pm	<u>**Questions and Answers, Discussion**</u>
1 15 pm	Coffee break
1 00 - 3 00	<u>**Round table**</u> Participants from the Russian side ■ Vice-chairmen of the SCC A Arifulin and V Vitryansky ■ Judges N Veseneva, N Ivannikova, O Naumov, G Shapkina
3 00 pm	<u>**Farewell Luncheon**</u>

JUDGE BETTY BARTEAU, Chief of Party, Russian-American Judicial Partnership

After receiving a law degree from Indiana University School of Law - Indianapolis, Judge Barteau was in private practice for 10 years During this time she also served as a deputy prosecutor, a defense attorney, county attorney and as a city court judge She was elected to the Marion Superior Court in Indianapolis, Indiana in 1974 where she served for 16 years In 1991 she joined the Indiana Court of Appeals, leaving that court in 1998 to become the Chief of the Russian American Judicial Partnership, a USAID funded project of the National Judicial College and Chemonics International based in Moscow, Russia This project is providing and developing judicial education and training for the Commercial and General Jurisdiction courts of Russia, as well as working with the courts in the development of technical support systems and legal publications

Judge Barteau received her LLM in the Judicial Process from the University of Virginia School of Law in 1994 She is past president of the Association of Family and Conciliation Courts and was a founding member of the National Association of Women Judges She has received many awards including being named Indiana Women of the Year in 1978 for her contribution in furthering equality for women in the business and professional fields

Judge Barteau is a 1975 graduate of the National Judicial College, has been on the faculty since 1978, and was the 1993 recipient of the Griswold Award for Excellence in Teaching She was a charter member of the NJC Faculty Council and served as its chair for the year 1990

JUDGE JOSEPH T WALSH, Supreme Court of the State of Delaware

Received B A with honors from LaSalle College, Philadelphia, in June, 1952 and received L L B degree from Georgetown University Law School in September, 1954 Was a member of the Editorial Staff, Georgetown Law Review Graduate - Judge Advocate General's School - University of Virginia, 1956 Admitted to District of Columbia Bar, October, 1954 Admitted to Delaware Bar, March, 1955

Engaged in general practice of law in Wilmington, Delaware, from 1958 to 1972 Served as Chief Attorney for the Legal Aid Society, 1958-60 Attorney for House of Representatives of the General Assembly, 1960-62 Chief Counsel to the Public Service Commission of Delaware, 1962 to 1970 Special Counsel to the Public Service Commission, 1970-72 Counsel to Wilmington Parking Authority 1962-72

Appointed Associate Judge, Superior Court of the State of Delaware July, 1972, appointed Vice Chancellor, Court of Chancery of the State of Delaware July, 1984, appointed Justice, Supreme Court of the State of Delaware September, 1985 Re-appointed Justice, Supreme Court of the State of Delaware October, 1997 Chairman, Criminal Code Revision Committee Chairman, Delaware Courts Planning Committee 1978-1995 Graduate - National College of Trial Judges Board of Directors, Einstein Institute for Science, Health & the Courts Adjunct Professor, Widener University School of Law Recipient - Herbert Harley Award, American Judicature Society, 1989, St Thomas More Award, 1996 Honorary Doctor of Laws, Widener University School of Law, 1997

JUDGE SIDNEY B BROOKS, United States Bankruptcy Court

A commercial law expert with more than 20 years of experience in commercial law, litigation, insolvency and bankruptcy and small business representation In Russia, advised Russian Arbitrazh (Commercial) Court chief judges on effective resolution of bankruptcy issues under current law and made recommendations for improvement of Russian law Since 1994, served as a presenter and faculty member at numerous conferences and training seminars, such as the USAID/Booz Allen & Hamilton-sponsored training programs for academics and professionals from the countries of the former Soviet Union Has extensive experience lecturing and presenting seminars on bank insolvency and bankruptcy issues in Eastern Europe and the NIS

Received his J D degree from University of Denver College of Law in 1971 Since 1988 has been holding the post of the United States Bankruptcy Judge in the District of Colorado

DAVID M VAUGHN, Deputy Chief of Party

Mr Vaughn currently serves as Deputy Chief of Party in Moscow for the Russian-American Judicial Partnership project with is assisting the judicial leadership of Russia to implement judicial reforms Prior to this assignment, her served in Almaty, Kazakhstan, as a volunteer liaison for the American Bar Association Central and East European Law Initiative, where he ran two fully-staffed field offices and was responsible for a variety of legal reform programs aimed at judges and lawyers While in Kazakhstan, he also worked closely with the Parliament on improving the quality of legislation David Vaughn obtained a B A in Russian language and an M A in political science from the University of Vermont in Burlington, and a J D concentrating in international law from the American University in Washington, D C He received Russian language training at the Pushkin Institute of the Russian Language in Moscow and the University of Khar'kov in Ukraine He has over six years experience in international, constitutional, and criminal law, and has a background in international affairs and human rights issues

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SECTION 1

BANKRUPTCY TRUSTEESHIP

Objective

the participants will have an understanding of the bankruptcy trusteeship in the US

The participants will study the following

BANKRUPTCY IS NOT BAD!

LIQUIDATION TRUSTEE – CHAPTER 7

REORGANIZATION TRUSTEE – CHAPTER 11 AND CHAPTER 13

ELEMENTS OF A SUCCESSFUL REORGANIZATION

ADDITIONAL MATERIALS AVAILABLE IN RUSSIAN

The presentation of
judge Sidney B Brooks,
United States Bankruptcy Court

BANKRUPTCY IS NOT BAD!

- "Bankruptcy" is not bad or negative or destructive It is not criminal! No system is more misunderstood than the bankruptcy system

- A bankruptcy law is an important, indispensable feature of a developing or mature, successful free enterprise system

- An economic system which is driven by competition, results in many successes and many failures A market economy needs a device, a "safety net" for those who "fail "

- A bankruptcy system allows the honest individual or business to get a fresh start

- Fraud, illegal conduct or malfeasance are not the cause of most bankruptcies Lost jobs, layoffs, a declining economy, medical problems, uninsured losses, and educational expenses cause most individual bankruptcies Businesses and farmers are also subject to forces they often cannot control such as loss of access to capital, disruptions in supplies or materials, mergers or acquisitions, adverse weather, labor unrest and strikes, new technology, and market forces

- Failed or failing businesses need, at least, the opportunity to reorganize their affairs if they can efficiently serve a useful community or economic purpose

- Reorganization of a weak business enterprise can save jobs, sustain a community, continue to generate taxes, maintain employee health insurance and savings programs, and foster ancillary businesses

- A rehabilitated business is good for its employees, suppliers, customers, neighbors, lenders, creditors, communities and its shareholders or partners

- A successfully reorganized business is likely to be much less costly than a new, start-up business

- If a business cannot reorganize, then its assets should be divided among its creditors in an orderly, fair and predictable fashion

- A free enterprise economic system needs investment Investment requires investors and risk takers Investors are less likely to risk their capital if failure means complete failure forever with no opportunity for a fresh start

- Investors, particularly foreign investors, are far more likely to invest their money in an environment that has a set of commercial and insolvency laws which are recognized, predictable and enforced

- A market economy should encourage entrepreneurs, not punish or "criminalize" them A good bankruptcy system does that

- A good bankruptcy system has safeguards to prevent fraud, abuse, deceit and misuse of bankruptcy If the creditors are vigilant in protecting their rights, the attorneys and authorities are diligent in attacking those who misuse the system, and the Courts are aggressive in enforcing the highest standards of ethics and fair play, the crooks cannot misuse the bankruptcy system

Hon Sid Brooks
April 1999

LIQUIDATION TRUSTEE – CHAPTER 7

- A panel of Trustees is selected, monitored, supervised and, if necessary, terminated by the Office of the United States Trustees in every judicial district

- Qualifications of Trustees

  Generally, Trustees are licensed attorneys with experience and training in business law Customarily they also maintain private law practice in business and bankruptcy matters Trustees must be bonded and not have any conflicts of interest or self-interest, either personally, professionally or financially

- Creditors may elect a single Trustee to manage liquidation of available assets of a debtor individual or business reorganization However, usually the U S Trustee simply appoints a panel Trustee

✎ Duties of a Trustee include

- Collect and sell assets of the debtor, distribute to creditors proceeds of sale

- Be accountable for all property
- Investigate financial affairs of debtor
- Examine, approve or object to claims of creditors
- If appropriate, oppose discharge of debtor's debts
- Provide information to and answer questions of creditors
- In those rare occasions when a Trustee temporarily operates the business before liquidating, Trustee must supply periodic financial information, pay taxes, account for everything

- Advise the Court on all matters of importance in administration of the estate and with regard to disputes between the estate and any creditor or the Trustee

- Advise the court on the issue of "substantial abuse" of the bankruptcy system

- File final report with the Court and creditors

REORGANIZATION TRUSTEE – CHAPTER 11 AND CHAPTER 13

- Duties include all those which apply to a Liquidation Trustee–Chapter 7

- Operate the business in lieu of the "Debtor-in-Possession," or old management

- Investigate acts, assets, liabilities, finances and operations of previous managers and report same to the Court and creditors

- Work with and answer questions of the Creditors' Committee   Prepare and distribute financial and operating data for the business on a routine basis

- Comply with rules of the Office of the United States Trustee which includes (a) filing an inventory of all assets, (b) reporting on monthly financial and operations activities, (c) reporting and paying tax and other compulsory obligations

- Employ professionals as needed attorneys, accountants, reorganization specialists

- File a plan of reorganization in cooperation with creditors and other parties-in-interest or ask the Court to convert or dismiss the case

Hon Sid Brooks
April 1999

ELEMENTS OF A SUCCESSFUL REORGANIZATION

- Prompt Filing of Bankruptcy Petition Timely filing of a bankruptcy petition before irreversible insolvency and overdue recognition of the business's problems

- Control Immediate and effective centralized control exerted over all assets and business operations of the debtor, by the debtor or its Trustee, after the bankruptcy petition is filed

- Creditor Moratorium Immediate and effective enforcement of the moratorium—or automatic stay—against creditors' collection efforts, litigation and foreclosures

- Creditors' Committee Prompt organization and balanced representation on a Creditors' Committee that is (a) attentive and active in the case, (b) knowledgeable about the debtor and bankruptcy law , and (c) reasonable in its dealings with the debtor

- Disclosure Full and timely disclosure (transparency) of debtor's finances, assets and business transactions is imperative Establishing an accurate and reliable set of books and records for the business

Hon Sid Brooks
April 1999

- Accountability of Management Management of debtor, whether a debtor-in-possession or Trustee, or Manager, should be open, responsive to creditors and the Court, and accountable for business administration and decisions

- Hard Choices Candid recognition of the true reasons for insolvency and the commitment and will to take the necessary, often painful, steps to cure the problems

- Cooperation Where feasible, cooperation, not conflict, among the different parties is essential, recognition of common interests rather than emphasis on self-interest can be decisive

- Negotiation The process of negotiation among interested parties is central and indispensable Negotiation—with inevitable compromise and accommodation—will make the difference between success and failure in a reorganization

- Plan of Reorganization A negotiated Plan of Reorganization which (a) comports with applicable law, and (b) treats parties in a fair and balanced manner can be the successful result of the reorganization process

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SECTION 2

THE DEFINING TENSION IN CORPORATE GOVERNANCE AND CORPORATE CRIMINAL LIABILITY IN THE UNITED STATES OF AMERICA

Objective

the participants will have an understanding of the defining tension in corporate governance in the US

The participants will study the following

THE DEFINING TENSION IN CORPORATE GOVERNANCE

CORPORATE CRIMINAL LIABILITY

Presentation by Justice Joseph T. Walsh
Supreme Court of Delaware

THE DEFINING TENSION IN CORPORATE GOVERNANCE IN AMERICA[*]

Introduction

The "genius of American corporate law" is its state-oriented federalism and its flexible self-governance, through independent directors and corporate counselors who have to make the system work

Enterprise, Ownership and Oversight Issues

Corporate governance issues often divide among "enterprise" and "ownership" issues in corporate decision-making and "oversight" issues in the board's nondecision-making monitoring role

Enterprise issues raise questions such as should we manufacture cars or widgets, and should the plant be in Perth or Pittsburgh? These issues are normally the proper domain of the senior management team There is little or no court interference in enterprise issues The board of directors should be responsible for formulating a strategic plan within which enterprise issues fit, although the board is usually not expected to carry out the detailed implementation Stockholder involvement in enterprise issues is usually nonexistent

[*]Extracts from Article by E Norman Veasey, Chief Justice of Delaware Supreme Court *The Business Lawyer*, February 1997, Volume 52, Number 2

Ownership issues raise questions such as should we merge our widget company with an automobile manufacturer and fend off unwanted suitors who wish to take control by a tender offer to the stockholders? It is the ownership issues which usually put corporate governance sternly to the test

Finally, there is one other major area of directorial responsibility which must be kept in mind That is the duty of oversight, where there is no business decision of the directors Directors must exercise reasonable care to see that company executives carry out their managerial responsibilities and comply with the law

The Business Judgment Rule

The business judgment rule can be stated simply in making a business decision, the directors are presumed to have acted independently, on an informed basis, in good faith, and in the honest belief that the decision is in the best interests of the corporation A business decision will normally be sustained unless the presumption is rebutted in either of two ways (i) the process, independence, or good faith of the directors is compromised, or (ii) the decision cannot be attributed to a rational business purpose

Ownership issues may sometimes implicate the traditional business judgment rule but often ownership decisions require an enhanced court scrutiny which goes beyond the traditional rule That enhanced scrutiny may take several forms, depending on the circumstances

Oversight responsibility does not implicate the business judgment rule because it does not involve business decisions Directors may be exposed to potential liability for violation of their oversight responsibility if they knew or should have known of managerial malfeasance, misfeasance or nonfeasance and did nothing about it, or if they otherwise abdicated their responsibilities.

A significant element of corporate governance in Delaware, and in many other jurisdictions, is the expectation that directors, in carrying out their duty to direct the management of the business and affairs of the corporation, will delegate many responsibilities to management, board committees and others Moreover, directors may rely in good faith on corporate records, management reports, board committees, and outside experts, provided that due care is exercised in selecting those upon whom reliance is placed

Increasingly in the United States directors are aspiring to high levels of sound corporate practice and good corporate governance models in decision-making and oversight This is true even though failure to adhere to those aspirational goals may not result in liability, and these governance models do not necessarily guarantee profitable management performance or freedom from lawsuits

Derivative Suits

A stockholder of a corporation may bring a derivative suit against directors and officers on behalf of the corporation in a state or federal court having jurisdiction If the stockholder qualifies to proceed with the litigation and wins, the recovery or equitable relief goes only to the corporation, not to the stockholder The court may award the stockholder reasonable attorneys' fees and expenses, depending upon the benefit conferred upon the corporation by the efforts of counsel for the stockholder

It is the corporation's cause of action which the stockholder seeks to vindicate That cause of action is an asset belonging to the corporation and only to the corporation. Like all other corporate assets, the corporation's cause of action should normally be managed by the board of directors Accordingly, the stockholder usually must demand that the board bring suit

What if the directors have a conflict because they are claimed to be the wrongdoers? By merely naming the directors in the suit, the plaintiff may not thereby unilaterally disqualify the directors If the stockholder can state facts with particularity which assert some reason to believe that the directors may be wrongdoers, the stockholder need not demand that the directors sue themselves The demand is excused and the stockholder may prosecute the action on the corporation's behalf. If the stockholder cannot plead facts showing a reasonable doubt that directors acted properly, the stockholder must demand that the board of directors take action. The board should respond promptly to that demand either by rejecting it (if the rejection is not wrongful) or by taking some action to vindicate the stockholder's demand. If demand is excused or wrongfully refused, the stockholder may assert the corporation's claim.

Direct and Class Actions

When a stockholder is injured directly (as, for example, when the corporation commits a material disclosure violation when seeking stockholder approval for a merger), the stockholder may sue directly on his or her own behalf. Sometimes a stockholder who is injured directly in such a manner may bring a class action, suing on behalf of all stockholders similarly situated. Class actions are governed by specific and detailed procedural rules. If the stockholder wins a class action, the recovery is distributed among the class members and the plaintiffs may be awarded reasonable attorneys' fees and costs by the court, depending on the benefit conferred upon the class. Both derivative and class actions may be settled, but only with court approval which may also involve the matter of attorneys' fees and costs.

Exculpation of Directors From Liability for Monetary Damages

Suppose there had been a material disclosure violation on a merger approval Perhaps injunctive relief could be obtained at an early stage before the merger is consummated If that fails or is not sought, however, can there be monetary damages awarded to the stockholder or the class against the directors? Perhaps, unless an exculpation statute applies.

Delaware and other states have a statute that permits the stockholders, through the certificate of incorporation, to exonerate completely or limit the exposure of directors for personal liability to the corporation or the stockholders for monetary damages based on a breach of their fiduciary That statute does not allow exoneration if the director is found to have committed a breach of the duty of loyalty, acts or omissions not in good faith, intentional misconduct, a knowing violation of the law, improper payment of dividends or improper personal benefit.

It should be noted that the exculpation statute protects only *directors acting as directors* from monetary damages Thus, for example, if the certificate of incorporation permits the maximum statutory exoneration, negligent but good faith disclosure violations would not subject the directors to liability for monetary damages Moreover, in such a case there would be no vicarious or other monetary liability against the corporate defendants if the directors were shielded by the statute

Nevertheless, injunctive relief is nevertheless available against the directors or the corporation, if warranted

Fiduciary Duties

Directors are fiduciaries to the corporation and the stockholders, and owe duties of loyalty and care to both They also owe a duty of full disclosure in certain circumstances The duty of care includes the requirement that directors inform themselves of all material information reasonably available to them before making a business decision This is a process requirement, and directors may be liable (unless exonerated by statute and charter provision) if they are found to be grossly negligent in the process This liability analysis may be subject to an entire fairness hearing

The fiduciary duty of loyalty may be implicated if directors have a material conflict of interest and cause the corporation to act or not to act in a way that benefits them personally, or if they do not act independently when making a business decision In such a case, directors may be held personally liable Duty of loyalty violations may also result in demand excusal in a derivative suit

Sometimes it is not easy or appropriate to place the conduct of directors in sharply defined cabins of care or loyalty Similarly, the duty of disclosure requires candor in disclosing all material information which would be important to a stockholder in deciding how to vote The failure to disclose that material could be fraud or a good faith omission

Independence of Directors

Directors will not be protected by the business judgment rule when making a business decision if they have a personal financial interest in the decision or if they do not act independently, *i.e* , free of domination or any motive except the merits of the corporate transaction Independence may become a critical issue in derivative litigation or in transactions where directors are alleged to be dominated by an interested party

Enhanced Scrutiny

If the business judgment rule is rebutted, the courts may employ some form of enhanced scrutiny Sometimes there is a requirement that the directors show the entire fairness of a transaction Moreover, if there is a sale of control, the directors must obtain the best price for the stockholders that is reasonably available for their stock

The Defining Tension

The defining tension in corporate governance today is the tension between deference to directors' decisions and the scope of judicial review Decisions of directors which can be attributed to any rational business purpose will be respected if they are made by directors who are independent and who act with due care and in good faith. Otherwise, courts may be called upon to apply some form of enhanced scrutiny

Directors have to ask hard questions, and seek and receive unvarnished advice Both lawyers and directors should ask themselves if they can or should "just say no" to a management which may be biased or bent on a problematic course of action Counsellors would do well to recite the comfortable as well as the chilling words of these and other opinions when giving corporate advice

It is a common sense axiom that a majority of independent, non-management directors gives the board flexibility to deal with threats to corporate control or the "demand" issue in derivative litigation Also, a board that has a general practice of acting independently—by, for example, regularly evaluating the CEO or having the independent directors meet alone regularly—will tend to find it comfortable to act independently in a crisis Such a board is not only practiced and capable of operating with genuine independence, but also appears credible and tends to "certify" the *bona fides* of management Perhaps a court will see it that way if litigation should ever become necessary

Why should directors not be independent and why should they not act independently? Should a director who is truly independent agree to serve as an "independent director" in an atmosphere where the corporation or the CEO makes a large contribution to a university of which the director is president? Should a partner or associate of a law firm agree to serve as an "independent director" when his firm regularly receives substantial fees from the corporation? On this latter point, I will say only that there is no *per se* prohibition against the practice of a lawyer serving as a director of a corporation which is a well-paying client of the lawyer's firm Indeed, that lawyer may be a very valuable board member The issue is whether he or she will be found to be independent in a critical setting where the board must act through independent directors. The Comment to Rule 1.7, Model Rules of Professional Conduct, states

> "A lawyer for a corporation who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict If there is a material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director "

Directors who are truly independent are sensitive to appearances This is not an argument that "structural bias" notions are uniformly valid Friendship, golf companionship, social relationships are not factors which necessarily negate independence There is no place in corporate America today for empty formalities, adversarial boards, chilly boardroom atmospheres, timidity, or risk-averseness Likewise, there is nothing to suggest that, on an issue of questioning the loyalty of the CEO, the bridge partner of the CEO cannot act independently as a director. To make a blanket argument otherwise would create a dubious presumption that the director would sell his or her soul for friendship Yet the directors must be aware of any appearance that they lack independence In short, the better practice is that each director should be like Caesar's wife above reproach

Presentation by Justice Joseph T Walsh
Supreme Court of Delaware

CORPORATE CRIMINAL LIABILITY IN THE UNITED STATES OF AMERICA

Introduction

Any discussion of criminal liability in the United States of America should assume two significant developmental factors· i) criminal law in the United States of America developed from English common law as it existed prior to the American Revolution, and ii) both private individuals and corporations are subject to Federal as well as State statutory law

Corporate criminal liability first emerged in the mid-1800s with the development of the doctrines of vicarious and strict liability in tort law Consideration of recent developments and expanding regulatory practice requires that corporate boards of directors reexamine policy and procedures in an effort to reduce the risk of exposure to criminal liability

I. COMMON LAW

Under prior English common law a corporation could not be convicted of a crime because a corporation was unable to form the requisite *mens rea* or "guilty mind" Early cases additionally supported such a conclusion by reasoning that corporations could not be imprisoned

In the mid-1800s with the development of vicarious and strict liability, employees' acts and intent began to be imputed to the corporation The courts recognized that corporations act through agents and that the interests of public welfare outweighed any inequity in holding the corporation responsible The development of these doctrines logically extended to corporate criminal liability.

In 1909 the United States Supreme Court first found that a corporation could be criminally liable for acts or omissions of an agent acting within the scope of his employment The Supreme Court affirmed the convictions of a railroad company relating to published rates and the giving of rebates to particular shippers In doing so the Court recognized that a corporation acts by its officers and agents, and that it was taking only one step farther than the principles already governing civil liability.

II THE MODEL PENAL CODE

In 1956, the American Law Institute considered the Model Penal Code section 2 07 providing for criminal liability for corporate conduct This section provides three bases of liability. i) a broad *respondeat superior* theory of liability for minor offenses or violations, ii) a theory of liability based on failure to discharge duties of affirmative performance, and iii) a restricted theory of liability for offenses defined in the Penal Code

Under the broad *respondeat superior* theory, a corporation is criminally liable for minor infractions and non-Code penal offenses when the statute creating the offense demonstrates a legislative purpose to hold corporations liable and that purpose plainly appears This theory of liability also requires that the agent be acting within the scope of employment and on behalf of the corporation

The second theory of liability imposes criminal liability on corporations for failure to discharge a specific duty imposed on the corporation by law The third theory provides that a corporation will be criminally responsible if the conduct constituting the offense is authorized, commanded, solicited, performed, or recklessly tolerated by the board of directors or a high managerial agent acting within the scope of employment and on behalf of the corporation The Code defines high managerial agent as corporate officers or agents having duties of such responsibilities that their conduct may fairly be assumed to represent the policy of the corporation

III STATE LAW

By 1988, only twenty-eight states had clearly established corporate criminal liability Twenty-four had done so legislatively, many patterned after the Model Penal Code Yet the vast majority of states that have adopted provisions based on the Model Penal Code have broadened and altered many of the corporate liability provisions

For example, a majority of the states have broadened the first theory of liability based on *respondeat superior* to include any statute that demonstrates the requisite legislative intent to hold corporations liable, including penal statutes or offenses more serious than a violation In Delaware, for example, under this theory of liability the offense must be a misdemeanor or a violation, and the statute must "clearly indicate a legislative intent to impose liability on a corporation "

Some states have also broadened the Code's application through their definition of "high managerial agent" pertaining to the third theory of liability. Only a minority of states with such a provision have followed the definition of the Model Code In Delaware, for instance, "high managerial agent" is defined to include any officer or agent in a position of comparable authority with respect to the formulation of corporate policy or the supervision in a managerial capacity of subordinate employees

With respect to potential defenses, some states, including Delaware have legislatively provided liability notwithstanding that the conduct constituting the offense was impermissible corporate activity or *ultra vires* A corporation may be criminally liable for employee conduct in contravention of stated corporate policy Federal cases have held that a *de facto* corporation may be criminally liable as well as successor corporations following a merger Also, a corporation may be prosecuted after dissolution if such action is authorized under the laws of the state of incorporation, such as by a provision authorizing any suit or proceeding against the corporation within a specified time period after the dissolution This stands in contrast to the common law which treated a dissolved corporation in the same manner as a deceased person

IV FEDERAL LAW

By the middle of this century, corporate criminal liability had more fully developed in the federal system Federal courts generally permit a corporation to be held criminally responsible if the agent acted within the scope of employment and for the benefit of the corporation Acting within the scope of employment relates to the agents actual or apparent authority An intention to benefit the corporation translates into a determination that the agents action was done with a view of furthering the corporation's business, independent of whether any actual benefit accrued Similarly, the fact that the agent also derived a benefit does not eliminate or diminish the resulting corporate benefit.

Federal courts have utilized the "collective knowledge" doctrine to find corporations criminally liable even when no single agent is found to be at fault. This doctrine permits the corporation to be criminally liable if the agents or employees collectively knew, or reasonably should have known of the existence of the criminal violation Recently Federal convictions of corporations have increased from a few dozen per year to hundreds per year

V PUNISHMENT

A corporation cannot be imprisoned Therefore a corporation cannot be prosecuted for a criminal offense punishable only by death or imprisonment Yet a corporation can be subject to a statute that provides for the payment of a fine or imprisonment, or both in the discretion of the court Courts have also held that a when two or more independent penalties are prescribed by statute, a penalty that can be imposed on a corporation will be invoked.

Historically, fines have been the principal punishment for criminally liable corporations In addition to a fine, a corporation may be ordered to pay restitution or may be placed on probation No state has adopted a system of sentencing comparable to the Federal Sentencing Guidelines State judges generally have a large amount of discretion in sentencing.

The Federal Sentencing Guidelines governing corporations and other business organizations took effect on November 1, 1991 The Guidelines were designed so that the sanctions imposed upon organizations will provide just punishment, adequate deterrence, and incentives for organizations to maintain internal mechanisms for preventing, detecting, and reporting criminal conduct

The Guidelines apply to most federal felonies and Class A misdemeanors, but do not apply to environmental, export control, and food and drug offenses A corporation's sentence under the Guidelines may be comprised of a remedial order, a fine, and probation for up to five years The remedial order in turn may include restitution, prevention of future harm, community service and notice to victims

Under the guidelines a court starts with an offense level dependent upon the nature of the crime and then derives a base fine The court also determines the corporations "culpability score" which may adjust the fine up or down based upon consideration of various aggravating and mitigating factors Aggravating factors include. i) participation in or willful ignorance of the offense by a high-level employee, ii) repetition of offenses, iii) willful obstruction of justice during the investigation, and iv) violation of probation or a court order. Mitigating factors include· i) the existence of an effective compliance program, ii) the voluntarily report of the offense, iii) full cooperation in the investigation, and iv) a clear demonstration of acceptance and responsibility for the offense

VI. EXAMPLES OF CORPORATE CRIMINAL LIABILITY

Federal securities laws provide that corporations can be subject to criminal prosecution for wilful violations of substantive provisions and regulations A corporation and three of its principals were recently indicted for conspiracy to engage in illegal trading on the floor of the New York Stock Exchange and also with falsifying required books and records Although eventually settled, two corporations were criminally investigated for the submission of false and unauthorized bids, and the entering into of unlawful agreements with respect to trading in financing and secondary markets And in 1994, a corporation was charged with securities fraud for misleading investors about the rates of return and tax status of investments in limited partnerships

Other examples of recent corporate criminal investigations and convictions include i) in 1993, a corporation was investigated for fraud in the manufacture and repair of airplane engine parts that resulted in a consent order, ii) 1990 corporate convictions based on two major environmental statutes for knowingly transporting and causing the transportation of hazardous waste to a facility without a permit, and for knowingly treating, storing or disposing of a hazardous waste without a permit, iii) a 1993 conviction for conspiracy and interstate transportation of obscene materials in violation of federal law, and iv) convictions for conspiracy, and making and using false documents on a matter within the jurisdiction of a federal agency related to the falsification of logbooks and records required to be maintained in connection with the commercial enterprise of producing blood plasma

VII RECENT DEVELOPMENTS

The recent trend, especially at the federal level, is to increase criminal investigation and prosecution of corporations Recognizing that fines have been viewed as simply a cost of doing business, recent legislative enactments not only increase the amount of the fines but also increase the potential jail terms to be served by those in charge

In 1991, California enacted the California Corporate Criminal Liability Act providing for potential criminal liability to corporations and their managers for knowingly concealing serious dangers from their employees or covering up harmful consumer product defects from regulatory authorities. This California enactment has been called the "Be-a-Manager, Go-To-Jail" law. Under the act, corporations and managers who have knowledge of a serious concealed danger, meaning information that would convince a reasonable person in the circumstances in which the manager is situated that the serious danger exists, must notify the relevant regulatory authority within fifteen days, or in the case of imminent risk of great bodily harm or death, immediately The corporation may be fined up to $1 million for a violation of the act

Federal criminal enforcement of environmental laws has also been on the increase With deterrence as the primary objective, stronger sanctions and new criminal penalties have been inserted into each major environmental statute For example, in 1987 Congress amended the Clean Water Act increasing potential jail time and inserting a "knowing endangerment" provision which imposes maximum penalties of up to fifteen years in prison and $1 million fines for organizations In 1990, the amendments to the Clean Air Act upgraded offenses to felony status and also inserted a "knowing endangerment" provision.

Presentation by Justice Joseph T Walsh
Supreme Court of Delaware

PIERCING THE CORPORATE VEIL: A COMPARATIVE ANALYSIS

A basic purpose of the formation of a corporation is to limit the liability of the shareholders to the capital contributed in exchange for their shares of stock Shareholders are not ordinarily liable for the obligations and debts of the corporation which is viewed as a separate entity Under certain circumstances, however, the law provides a means to disregard the corporate form and the general rule of limited liability By "piercing the corporate veil," one has succeeded in establishing such circumstances, and is permitted to look directly to the shareholders for satisfaction of corporate obligations

I DEVELOPMENT OF THE DOCTRINE

The ability to "pierce the corporate veil" developed through case law State incorporation statutes make no express provision for the application of the doctrine, although statutes and court rules permit such suits and provide procedures The Model Business Corporation Act provides that shareholders are not personally liable for the acts or debts of the corporation unless otherwise provided in the articles of incorporation or the shareholder becomes personally liable "by reason of his own acts or conduct." Similarly, Delaware provides that a corporation may include in the certificate of incorporation a provision "imposing personal liability for the debts of the corporation on its stockholders ... to a specified extent and upon specified conditions, otherwise, the stockholders ... shall not be personally liable for the payment of the corporation's debts except as they may be liable by reason of their own conduct or acts" The courts were left to articulate the "tests" or "factors" to be utilized in determining under what circumstances it would be deemed appropriate to "pierce the veil"

The courts traditionally ruled that the doctrine was to be used to "prevent fraud, oppression or illegality" and to "achieve equity" Certain factors also emerged First, only closely held corporations, those with one or a few shareholders, have had their corporate veils pierced A recent study found that piercing only occurs in close corporations or within corporate groups (parent/subsidiary or sibling corporations) and does not occur in publicly held corporations [1]

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[1]Thompson, Robert B, *Piercing the Corporate Veil An Empirical Study*, 76 CORNELL L REV 1036 (1991)

Courts also appear to draw a distinction between voluntary and involuntary creditors The view is that a voluntary creditor, such as a supplier, customer, lender, or employee can anticipate and account for the risks of dealing with a corporation and the limited liability of its shareholders

Another consideration which might influence a court faced with the issue of piercing the corporate veil is whether corporate formalities, such as issuing stock, holding shareholders' and directors' meetings, and keeping corporate minutes have been followed and observed Justifications for applying these factors are i) by disregarding the corporate formalities, those involved should not be able to benefit from the mere corporate existence — essentially to be treated as a corporation, one should act like a corporation, ii) the lack of corporate formalities misled or confused third parties as to who they were dealing with, and iii) the failure to observe corporate formalities may raise the issue of the improper usage of corporation funds by a shareholder to the disadvantage of actual or potential creditors.

The commingling of corporate and personal assets is another consideration taken into account by the courts when piercing the corporate veil Again, with the protection of creditors in mind, the theory is that the commingling of assets indicates a disregard for the legitimate expectation of a corporate creditor that the company assets will be available to meet its obligations Confusion of a subsidiary's affairs has often been cited by the courts as a reason to disregard separate incorporation and has provided one of the bases for the Enterprise Liability Doctrine which is used to disregard multiple incorporations of the same business. A recent study found that courts are more inclined to pierce the veil between sibling corporations than in a parent subsidiary context

Yet another factor involved in a court's decision to pierce the corporate veil relates to undercapitalization or purposeful failure to insure A business that has little or no capital, without some additional aggravating factors, is usually not subject to piercing The courts look to whether the corporation is operated with sufficient capital to meet the anticipated business risks

Piercing may also be influenced by the actions of the participating parties Those shareholders who are not active in the business will not be as liable as those whose actions disadvantaged the creditors For example, an individual shareholder who also served as a director or officer is more likely to be liable The most determinative factor in cases involving the piercing of the corporate veil is the presence of a misrepresentation Shareholders who mislead creditors into believing that personal guarantees are unnecessary are more likely to be held personally liable for the corporations obligations Finally, the recent study found that courts were more inclined to pierce in environmental and other cases where "there is a strong regulatory purpose" and that this is additionally reflected in those cases by the courts' limited usage of traditional piercing factors.

II COMPARATIVE ANALYSIS

Article 56(3) of the Civil Code of the Russian Federation ("the Civil Code"), which came into effect on January 1, 1995, sets down the general rule of limited liability[2] Article 56(3) provides that "[t]he founder (participant) of a legal entity or the owner of its assets do not incur the liability for the obligations of a legal entity, and a legal entity is not liable for the obligations of a founder (participant) or owner, with the exceptions set forth by [the] Code or the foundation documents of a legal entity"

Thus, the Civil Code allows the foundation documents (charter and foundation agreement in the case of a limited liability company, and charter for a joint stock company) of the entity to alter the general rule of limited liability, just as the Model Business Corporation Act § 6 22(b) and the Delaware General

[2]This analysis of the Russian laws relies heavily upon Zenina, Zhanna A , *Special Report The Liability of Shareholders and Officers Under the Russian Federation Laws on Joint Stock Companies and Limited Liability Companies*, Vol 8, BNA's Eastern Europe Reporter, p 561 (1998)

Corporation Law § 102(b)(6) so permit But unlike American statutory corporation law which left to the courts to define what "acts or conduct" might give rise to personal liability of the shareholder, the Civil Code, the Law on Joint Stock Companies ("the JSC Law"), and the Law On Limited Liability Companies ("the LLC Law"), have provided that certain persons may bear liability i) for causing the insolvency or bankruptcy of a joint stock company or a limited liability company, ii) for the losses of a joint stock company or a limited liability company, and iii) for contractual obligations of a joint stock company or limited liability company to third parties

The Civil Code and Laws specify the potential bearers of liability including parent companies that are shareholders of joint stock companies and participants of limited liability companies, the board of directors or supervisory council, members of the executive body or individual executive officers, an individual manager, and additionally an external corporate manager of a joint stock company. In the case of insolvency or bankruptcy persons who have the right to give "binding instructions" to a joint stock company or limited liability company (unless it is a parent) may incur liability Further, if the person who has the right to give binding instructions is a parent company, liability for losses and contracts can also incur An "opportunity to direct the activity of a company," broader than a right to "give binding instructions," also creates a potential basis for incurring liability and may arise through controlling participation or in accordance with a contract.

In American general corporation law, "piercing the corporate veil" is usually limited to actions seeking to hold shareholders liable for more than their initial investments In actions against officers, directors or shareholders for the debts of the corporation, Delaware law requires first that the creditor of the corporation have obtained a judgment against the entity Efforts to hold directors, officers and employees liable normally proceed through different procedural channels such as derivative suits and are based on other theories of liability, such as fiduciary duties Suits against directors, officers and employees also may face various hurdles For example, general corporation law provides that a corporation may indemnify officers, directors, employees and agents if they acted in good faith and reasonably believed their conduct was in or not opposed to the best interests of the corporation The theory is that in order to encourage qualified persons to aid in the management of a corporation, and correspondingly to take business risks that are in the best interests of the company, the potential exposure to personal liability needs to be reduced or minimized

A. Bankruptcy

Article 56(3) of the Civil Code provides that "the founders (participants) of a legal entity, owner of the property of a legal entity or other persons who have the right to give binding instructions or otherwise have the opportunity to direct the activity of a legal entity can bear secondary liability for the insolvency of a legal entity, provided that such legal entity lacks sufficient assets for fulfillment of its obligations " The JSC Law only adds a requirement of advance knowledge that due to the use of the right to give binding instructions or opportunity to direct the activity, the subsidiary will become insolvent It is unknown whether actual knowledge is determined by an objective or subjective standard The LLC law does not require knowledge but only that the faulty actions of the parent caused the bankruptcy

The Russian Insolvency Law has two main requirements necessary for a bankruptcy declaration — three months having passed since the date of failure to fulfill an obligation, and the size of the debt must exceed 500 times the minimum monthly wage established by law In the United States, bankruptcy is governed by federal law State corporation statutes, however, do provide for the appointment of a receiver by a court for an insolvent corporation An insolvent corporation is generally either unable to pay debts as they become due in the usual course of business or has liabilities exceeding its assets Federal bankruptcy judges follow state law when applying the doctrine of piercing the corporate veil. Therefore the same factors discussed previously, i e , the number of shareholders and their role, the observance of corporate formalities, the presence of fraud or misrepresentation, the commingling of assets, undercapitalization, and the presence of fraud or misrepresentation, will be utilized in the court's decision to pierce

B. Losses

The Russian Civil Code defines losses essentially as real damages and lost profits The Civil Code permits liability for losses to be limited through contract A parent may be liable for losses incurred by a joint stock company if the parent company had the right to give binding instructions or the opportunity to direct the activity of the company and then used either of these, knowing in advance that such action would cause the losses. The LLC Law, as with bankruptcy, does not require the advance knowing of the parent, but provides for liability if the parent caused the loss through faulty actions. Therefore the LLC Law provides a broader base of potential liability than does the JSC Law

Officers who enjoy certain decision making and managerial powers may incur liability in even more circumstances Under both the JSC and LLC Laws, individuals may be jointly and severally liable for losses The Laws provide that ordinary business practices and "other relevant considerations" shall be taken into account

In the United States, shareholders will not be liable for the losses of a corporation unless a court has decided to pierce the corporate veil in an effort to prevent fraud, oppression or illegality and to achieve equity Directors of the corporation, who pursuant to statute are the ultimate managers of the company, are protected by the business judgment rule The business judgment rule creates a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation The presumption may be rebutted by evidence of a breach of any of the board's triad of fiduciary duties, loyalty, good faith and due care

The Russian Laws appear to step in the direction of a business judgment rule. However, taking into account business practices and "other relevant considerations" does not appear to rise to the level of a presumption protecting directors and recognizing the fundamental principle that the business and affairs of a corporation are managed by or under the direction of its board of directors

C. Contractual Liability

The Russian Civil Code provides that a parent with the right and authority to give binding instructions to the subsidiary assumes joint and several liability with that company for transactions taken in fulfillment of those instructions The JSC Law again utilizes the concept of binding instructions and opportunity to direct activity but requires the right to give binding instructions be provided by agreement or charter The LLC Law again does not require that such a right be so established

In the United States, the recent study found that courts pierce the veil more often in contract cases A recurring theme or rationale in these decisions focuses on misrepresentation As with losses, shareholders are not liable in the United States unless a court has decided to pierce the corporate veil And again, directors will not be liable absent a breach of fiduciary duty