DIRECTORS' FIDUCIARY DUTIES: SHOULD DELAWARE'S APPROACH BE FOLLOWED IN UKRAINE?

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Abstract

The new Law of Ukraine "On Limited Liability and Additional Liability Companies" is aimed at significant improvement of a regulatory framework and corporate governance of a limited liability company, which is the most common type of legal entities in Ukraine. However, one of its most controversial novelties is the express establishment of some fiduciary duties of directors. In light of these legislative changes, this thesis analyzes the approach of the State of Delaware with regard to regulation and limitation of fiduciary duties of directors (within LLCs and corporations) and the possibility of its implementation in Ukraine to enhance corporate governance within Ukrainian LLCs.

The analysis is based on the comparative examination of legislation (both effective legislation and legislative history of regulations with regard to fiduciary duties) as well as relevant court practice of Delaware and Ukraine. The first part of the thesis puts into question the general concept of directors' fiduciary duties. The second part discusses the scope of fiduciary duties in Delaware and Ukraine. The third part of this thesis is devoted to a critical analysis of different approaches of limiting fiduciary duties, focusing mainly on the business judgment rule and the possibility to eliminate and modify fiduciary duties by various agreements. The analysis of current policy concerning directors' fiduciary duties in Ukraine reveals its inconsistency. The thesis proposes to amend Ukrainian legislation in the terrains of corporate and labor law and provides some implications of Delaware's approach in Ukraine.

Introduction

Limited liability company *(hereinafter - LLC)* is the most common type of legal entities in Ukraine with 613 055 LLCs registered in a state register as of 01 September 2018 (the closest competitor is a private enterprise with the amount of 199 972).[1] Given the significant role of LLCs in Ukrainian economy, the legislator took many actions to incentivize the prosperous functioning of such companies. Thus, corporate law of Ukraine became a subject of conceptual amendments recently.

Previously, LLCs were regulated mostly by the outdated provisions of the Law of Ukraine "On Companies",[2] which date back to 1991, as well as conflicting provisions of Civil and Commercial Codes of Ukraine.[3] However, the new Law of Ukraine "On Limited Liability and Additional Liability Companies" *(hereinafter - the New Law*), which came into force on 17 June 2018, is considered to introduce significant improvements of the regulatory framework and corporate governance within LLCs.[4] The New Law is deemed to contain a modern approach, according to which the participants of an LLC have a wide discretion, in particular, in determining the rules for their corporate governance, the system by which LLCs are directed and controlled. However, one of the most controversial novelties of the New Law is the express establishment, for the first time, of some fiduciary duties of directors and supervisory board members. The explanatory notes and commentaries to the New Law clarify that the adoption

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[1] 'The Number of Legal Entities by Organizational Forms' (Statistical Data provided by State Statistics Service of Ukraine) <http://www.ukrstat.gov.ua/edrpoy/ukr/EDRPU_2018/ks_opfg/ks_opfg_0918.htm> accessed 13 October 2018.

[2] The Law of Ukraine, 'On Companies' [19 September 1991], No. 1576-XII <http://zakon.rada.gov.ua/laws/show/1576-12> accessed 13 October 2018.

[3] Thsyvilnyi Kodeks Ukrainy [ThK UA] [Civil Code]; Hospodarskyy kodeks Ukrainy [HK UA] [Commercial Code].

[4] The Law of Ukraine, 'On Limited and Additional Liability Companies' [6 February 2018], No. 2275-VIII, Art. 40 <http://zakon.rada.gov.ua/laws/show/2275-19> accessed 30 December 2018.

of such provisions was driven mainly by successful practical application of fiduciary duties in common law jurisdictions, notably, in the State of Delaware (*hereinafter - Delaware*).

The development of directors' fiduciary duties may have a crucial effect on Ukrainian economy. Since directors, as fiduciaries, are normally entrusted with powers of decision-making on behalf of an LLC, the issues arising out of the relations between directors and shareholders as a class are considered to constitute one of the core corporate law problems.[5] As was described by Berle and Means, there is a great divergence of interests between ownership of an enterprise (represented by shareholders) and control over it, which "tends to move further and further away from ownership and ultimately lie in the hands of management itself, a management capable of perpetuating its own position".[6] As a result of such confrontations in interests, the shareholders seek to exercise effective control and monitoring over the managers' behavior.[7]

Apart from this, the articulation of fiduciary duties by regulations in civil law countries is also necessary for the investors to be secure that their rights will be protected.[8] Fiduciary duties are meant to embody "the notion of how and in whose interest … directors are supposed to act, set the standard by which … actions are to be judged, and, therefore, provide a basis for the enforcement of investor rights under any system of law."[9] As was recommended by the United Nations Environment Programme Finance Initiative, policymakers and regulators should encourage and require the director's fiduciary duties so as to attract more foreign

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[5] Paul L Davies, The Board of Directors: Composition, Structure, Duties and Powers (Conference on Company Law Reform in OECD Countries: A Comparative Outlook of Current Trends, Stockholm, December 2000) https://www.oecd.org/daf/ca/corporategovernanceprinciples/1857291.pdf.
[6] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 116 (6th ed. 1991).
[7] This thesis uses the terms "control" and "management" as complementary; however, in major companies they may need a certain degree of separation. *See, e.g.,* ANDREAS FLECKNER & KLAUS J. HOPT, COMPARATIVE CORPORATE GOVERNANCE: A FUNCTIONAL AND INTERNATIONAL ANALYSIS 43 (2013).
[8] Ira M. Millstein, Non-Traditional Modes Of Enforcement, Speech delivered at "Enforcement and Corporate Governance: Three Views" Global Corporate Governance Forum 11, 16 (2005).
[9] *Id*.

investments.[10] Therefore, the analysis of directors' fiduciary duties as part of corporate governance of LLCs constitutes not only a useful tool for lawyers and entrepreneurs with interests in Ukrainian directors' duties but can also become a ground for the broader research, since it has never been a popular subjects among Ukrainian scholars.

The thesis problem and, consequently, the research questions of this thesis are closely connected with the adoption of the New Law. The main research questions of this thesis, which will be addressed in a comparative analysis, are connected to the scope of directors' fiduciary duties, possible ways of limiting directors' fiduciary duties and an existence of the business judgment rule.

The abovementioned research questions constitute the basic ground for further considerations to be examined in this thesis. The main idea of the thesis is the analysis of the approach of Delaware regarding regulation and limitation of fiduciary duties of company's[11] directors and the possibility of its implementation in Ukraine as an instrument to enhance corporate governance within Ukrainian LLCs. Apart from that, the examination of Ukrainian current policy concerning directors' fiduciary duties will also reveal its inconsistencies and regulatory discrepancies (for example, the problem that the business judgement rule is often linked to labor law instead of corporate law). Thus, the thesis will also propose to amend Ukrainian legislation in the spheres of corporate and labor law.

Evidently, the thesis will cover two jurisdictions: Ukraine (as an emerging country reforming its corporate law regulations) and Delaware (as it is often used as an example of

[10] Rory Sullivan at al., REPORT FIDUCIARY DUTY IN THE 21ST CENTURY 1, 21, available at https://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf.

[11] This thesis uses the terms "company", "LLC" and "corporation" indistinguishably, except for the occasions when the context requires usage of the precise form of legal entity (either to "LLC", "corporation" or "joint stock company").

successful corporate law jurisdiction). The justifications for comparing Delaware and Ukraine are twofold.

First of all, the importance of Delaware as one of the most developed jurisdictions in the sphere of formation of business entities and corporate law cannot be overestimated. As indicated on the website of Delaware's Division of Corporations, "the State of Delaware is a leading domicile for U.S. and international corporations. More than 1,000,000 business entities have made Delaware their legal home. More than 66% of the Fortune 500 have chosen Delaware as their legal home".[12] This may be particularly attributed to the extensive experience of Delaware courts in corporate disputes, which resulted in better guidance on matters of corporate governance. Delaware courts are referred to as an engine of the Delaware corporate law with the feature of seeking a "nuanced middle ground between board and shareholder interests".[13]

Secondly, legislative history of the New Law demonstrates that the approach of Delaware concerning directors' fiduciary duties and business judgement rule has been taken into account during its drafting. Such fact is clearly indicated not only in the official Explanatory Note to the New Law,[14] but also in a number of materials prepared by the supporters of this new piece of legislation (*e.g.,* by some Ukrainian Members of the Parliament who are considered to be initiators of the New Law).[15]

[12] 'Delaware Division of Corporations. About the Division of Corporations' <https://corp.delaware.gov/aboutagency/> accessed 13 October 18.
[13] Willem J.L. Calkoen, The One-Tier Board in the Changing and Converging World of Corporate Governance: a comparative study of boards in the UK, the US and the Netherlands 120 (Oct. 11, 20111) (unpublished PhD dissertation, the Erasmus University Rotterdam) (on file with the Law Library of the University of Amsterdam).
[14] *Explanatory note to draft of the Law of Ukraine 'On Limited and Additional Liability Companies'*, Verkhovna Rada of Ukraine, http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=59093.
[15] *Explanatory note to draft of the Law of Ukraine 'On Limited and Additional Liability Companies'*, All-Ukrainian Public Organization "Ukrainian Bar Association", https://uba.ua/documents/doc/pojasnjuvalna_zapyska.pdf.

As noted by Justin Cyubahiro, the problems with corporate governance may be attributed, in particular, to the "disinclination to transplant good lessons from precedent cases, more particularly, in other jurisdictions in another hand and leniency of a system compounds its failure to address the wrongful actions, which in the end whip up repeated infringements on regulatory devices".[16] Thus, comparative analysis of Delaware's law may provide a useful guidance for the drafters of Ukrainian legislation.

The main focus of the methodology of this thesis is "legal hermeneutics" that concentrates on the identification of certain implications for transformation of Delaware's approach into Ukrainian domestic legislation and jurisprudence. Moreover, the "comparative approach" will be used for examining legislative acts, court practice and scholarly materials as a basis for further comprehensive analysis of Delaware's and Ukrainian corporate law regulations. The research will be supplemented by the historical method for the analysis of the development of directors' fiduciary duties.

This thesis will proceed in four parts. The first part is concerned with defining the general concept of directors' fiduciary duties. It discussed the meaning and origins of fiduciary duties, overviews the main beneficiaries of fiduciary duties and compares their scope in Ukraine and Delaware. The second part is dedicated to an overview and comparison of the duties of care, loyalty and good faith in both jurisdictions. The next part proceeds with the comparative analysis of the business judgment rule and the possibility to limit fiduciary duties by various agreements. Finally, the thesis assesses whether it is viable to implement the Delaware's approach in Ukraine and proposes some conceptual amendments to Ukrainian legislation.

[16] Justin Cyubahiro, *Directors' Fiduciary Duties: Rwandan Companies Act Choice And The Possibility Of Progress*, 3 INTERNATIONAL JOURNAL OF LAW 6,7 (2017).

Chapter 1. The notion of fiduciary duties

This chapter discusses the general concept of the directors' fiduciary duties. First, it gives an overview of the notion of fiduciary duties as such by discussing their meaning and origins. Then, it analyzes the ultimate beneficiaries of fiduciary duties and highlights the existence of such phenomenon as "insolvency zone" which modifies the list of fiduciary duties' beneficiaries. Finally, this chapter outlines directors' fiduciary duties both in Delaware and Ukraine. It should be noted that the duties of directors discussed in this thesis as such are not referred to as "fiduciary duties" in Ukraine mainly because the notion of fiduciary duties is a product of the common law countries. However, this chapter explains why one can, nevertheless, speak of their existence and development in Ukraine. Since the directors' fiduciary duties are better developed in Delaware than in Ukraine, the jurisdiction of Delaware is the main focus of this section.

1.1. The meaning and origins of fiduciary duties

The concept of fiduciary duties evolved to deal with the principal-agent problem in the context of corporate law. The core of this problem is that it arises when one person, the principal, authorizes another person, the agent, to undertake discretionary actions that may affect the welfare of the principal.[17]

In order to comprehend the meaning and notion of fiduciary duties, a closer examination of the relationships between the directors and the company they manage is needed. Such relationships are described as "fiduciary relationships". According to the Black's Law Dictionary, a fiduciary relationship is one "in which one person is under a duty to act for the benefit of another on matters within the scope of the relationship."[18] Fiduciary relationships

[17] *See* ROBERT H. SITKOFF, AN ECONOMIC THEORY OF FIDUCIARY LAW IN PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 148 (Andrew Gold & Paul Miller eds., 2014).
[18] BLACK'S LAW DICTIONARY 1315 (8th ed. 2004).

involve discretionary authority on the part of the fiduciary and dependency and reliance on the part of the beneficiary.[19] As described by Irit Samet, there is one structural feature of the fiduciary relations - "sharp inequality that stems from the vulnerability and dependency of the principal upon the fiduciary".[20] Indeed, since corporate governance permits the separation of ownership and control in the company and the directors manage the business affairs for the benefit of the shareholders[21], they are subject to the rules on fiduciary relationships. The core idea of fiduciary relationships can be expressed through the analysis of the agency theory – directors as agents for shareholders and company as principals do not necessarily have the interests of principals at heart when they take decisions on behalf of the company.[22] The New York Court of Appeals described the underlying rationale of such fiduciary relationships as follows:

> Because the power to manage the affairs of a corporation is vested in the directors and majority shareholders, they are cast in the fiduciary role of "guardians of the corporate welfare". In this position of trust, they have an obligation to all shareholders to adhere to fiduciary standards of conduct and to exercise their responsibilities in good faith when undertaking any corporate action, including a merger.[23]

The need for directors' fiduciary duties may not be straightforward. Indeed, as argued by some scholars, "shareholders who can appoint and remove managers should have no need to hobble managerial discretion with legal constraints".[24] However, as described above, the

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[19] Edwin W. Hecker, Jr., *Fiduciary Duties in Business Entities*, 54 U. KAN. L. REV. 923, 925 (2006).
[20] PAUL B. MILLER & ANDREW S. GOLD, CONTRACT, STATUS, AND FIDUCIARY LAW 140 (2016).
[21] *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 684, 204 Mich. 459, 507 (Mi. 1919).
[22] JEFFREY N. GORDON & WOLF-GEORG RINGE, THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 160 (2018).
[23] Alpert v 28 Williams Street Corp., 483 N.Y.S.2d 667, 673 (N.Y., Nov. 29, 1984).
[24] REINIER H. KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL Approach 69 (2017).

agency problems within the company are omnipresent and, thus, cannot be eliminated. Therefore, fiduciary duties serve the function of a constraint against possible abuses of directors as agents of principals.[25]

As for the term "fiduciary duty", it was defined by using a descriptive method as:

> A duty of utmost good faith, trust, confidence and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary (such as a lawyer's client or a shareholder); a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person (such as the duty that one partner owes to another).[26]

The reason for such an extensive and descriptive explanation of the fiduciary duty is the fact that such duties were developed mainly as the product of equity and, thus, their origins are quite unique.[27] As rightly pointed out by some scholars, the word "fiduciary" itself can be described as manifestly unstable, since it is an "etymological chameleon" that can be used in different ways (as a noun and as an adjective) and in different contexts.[28] Moreover, although the term "fiduciary duty" has been actively used in the law-making process, no legislator has ever tried to provide a comprehensive definition of it leaving such matter to the interpretation of the courts.

The origins of fiduciary duties are under the debate among scholars – some trace the origins to the trust relationships, while others are making references either to property or contract law.[29] For example, Irit Samet refers to fiduciary doctrine as to "a successful brainchild

[25] *Id.*
[26] BLACK'S LAW DICTIONARY 545 (8th ed. 2004).
[27] Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 880 (1988).
[28] ANDREW STAFFORD & STUART RICHIE, FIDUCIARY DUTIES: DIRECTORS AND EMPLOYEES 6 (2015).
[29] Julian Velasco, *Fiduciary Duties and Fiduciary Outs*, 21 GEO. MASON L. REV. 157, 216 (2013).

of the Courts of Equity, and that it should be preserved as a distinct bundle of legal rights and duties".[30] Leonard I. Rotman describes the origins of directors' fiduciary duties as follows:

> When fiduciary law was initially developed in English law, it was not distinguished terminologically from the concept of the trust. At that time, it was a common practice to describe a variety of equitable causes of action that involved the reposing of confidence by one person in another, including what we would now call breaches of fiduciary duty or breaches of confidence, as "trusts". Over time, fiduciary law expanded into the realm of non-trustees who occupied positions of trust and confidence or who were entrusted by others for particular purposes but did not satisfy the criteria associated with express trusts.[31]

An interesting and unique idea was purported by Myron T. Steele, former Chief Justice of the Delaware Supreme Court (2004-2013) by tracing the development of fiduciary duties to Roman Law and biblical principles, which led to the conclusion that "purpose of fiduciary duties is to serve as the moral pulse of our society as we define and set expectations for business relationships among ourselves."[32]

The most recognized approach is to refer to the trust law origins of fiduciary duties, while other ideas pursued by legal scholars put an emphasis only on particular aspects of fiduciary duties. Although, as noted by Andrew Stafford and Stuart Richie, the fiduciary relationship is a "concept in search of a principle", the worldwide trend is to view such relationships as a "trust-like" relationships because the fiduciary is "someone whom one can trust and rely on".[33] In this respect, the summary provided by Professor Deborah A. DeMott is commendable:

[30] MILLER & GOLD, *supra* note 20, at 140.
[31] Leonard I. Rotman, *Fiduciary Law's Holy Grail: Reconciling Theory and Practice in Fiduciary Jurisprudence*, 91 B.U. L. REV. 921, 972 (2011).
[32] Myron T. Steele, *The Moral Underpinnings of Delaware's Modern Corporate Fiduciary Duties*, 26 NOTRE DAME J.L. ETHICS & PUB. POL'Y 3, 24 (2012).
[33] STAFFORD & RICHIE, *supra* note 28, at 12.

> Fiduciary obligation has a number of characteristics that classify it among the law's most exotic species. Its origin in Equity and its continuing tie to Equity's legacy make it unusually context-bound as a legal obligation. The considerable variety of relationships in which parties are bound by fiduciary obligation further complicates the analysis. Determining whether fiduciary obligation applies in a particular context and what requirements inhere in the imposition of fiduciary obligation demands recognition of this situation-specificity.[34]

Indeed, there is no reason not to support the abovementioned idea. Given the complexity and development of corporate governance within companies, the origins and meaning of the concept of fiduciary duties require rather a specific analysis than generalization.

1.2. Beneficiaries of fiduciary duties

Moving on to the beneficiaries of fiduciary duties, it is notable that the term "fiduciary duty" is used to refer to the duties that directors owe to the company and its shareholders. As was observed by the former Delaware Supreme Court Chief Justice E. Norman Veasey, such "formulation is harmless in most instances because of the confluence of interests, in that what is good for the corporate entity is usually derivatively good for the stockholders."[35] However, by reference to *Paramount Communications, Inc. v. QVC Network, Inc.* and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, which demonstrate that in case of change of control the directors must seek to attain the best transaction reasonably available for the stockholders ("[t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company"[36]), the author argues

[34] Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 923 (1988).
[35] E. Norman Veasey; Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004 - A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1431 (2005).
[36] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del.,1986).

that in some cases the focus is directly on the interests of stockholders.[37] Interestingly, the author concludes that nevertheless the directors owe fiduciary duties to the corporation, and not to the stockholders, which is justified by "emphasis on board governance, namely, that the board's duty is to do what is best for the corporation".[38] This discussion as to whether the directors owe fiduciary duties to the company or its shareholders undoubtedly reminds the tension between the conservative shareholder-wealth-maximization school of corporate legal thought and the progressive social-responsibility school.[39] Without getting into the details of such tension, it is notable that it is yet to be seen which school of legal thought prevails in practice. Moreover, some scholars argue that the interests of shareholders and other stakeholders shall be considered closely related nowadays as the company can simultaneously satisfy both groups.[40] Therefore, it is of little significance to whom are the directors' fiduciary duties owned – to the company itself or to its shareholders, since the generally acknowledged approach is that both the company and its shareholders shall be deemed such beneficiaries.[41]

Besides, the list of beneficiaries of fiduciary duties may be reasonably broadened. There are two main categories of such additional beneficiaries within fiduciary duties concept: creditors and third parties.

With regard to the creditors, the directors are considered to owe fiduciary duties to them when it comes either to the future insolvency or already commenced insolvency proceeding. In *Geyer v. Ingersoll Publications Co.*[42] the court held that the directors of a corporation owe a

[37] Veasey & Di Guglielmo, *supra* note 34, at 1431 (footnotes omitted).
[38] *Id.*
[39] *See* Adam Winkler, *Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History*, 67 LAW AND CONTEMPORARY PROBLEMS 109, 133 (2004).
[40] M.C. Schouten, The Decoupling of Voting and Economic Ownership (June 22, 2012) (unpublished PhD dissertation, the University of Amsterdam) (on file with the Law Library of the University of Amsterdam).
[41] *See, e.g.*, ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 201 (6th ed. 1991) (arguing that "the director is a fiduciary for all of the individuals concerned as well as for the mythical corporate entity as a whole").
[42] Geyer v. Ingersoll, 621 A.2d 784, 787 (Del. Ch. 1992).

fiduciary duty to the corporation's creditors upon “insolvency in fact” or at the moment its liabilities exceed the fair market value of its assets.[43] Based on the ordinary literal meaning of the word “insolvency”, the *Geyer* court put an emphasis that “[t]he insolvency exception arises upon the fact of insolvency rather than the institution of statutory proceedings.”[44] Analyzing the importance of this court decision, Stephen R. McDonnell stated that the *Geyer* case may have a profound impact on Delaware’s corporate governance.[45] The term “zone of insolvency” evolved exactly due to the recognition of the directors’ fiduciary duties under the threat of the possible insolvency proceeding. Logically, J. William Callison reasons that “Delaware case law contemplates that the creditor shift begins when a firm enters the zone of insolvency and continues, presumably with increasing effect, through the point when the firm is insolvent with no reasonable possibility of continuing as a going concern.”[46] Andreas Engert, arguing on the same point, states that irrespective of the fact that it is still heavily contested at which point directors’ fiduciary duties “shift” to creditors (so-called “metaphysical boundaries of the zone of insolvency”), Delaware case law proves that “in the vicinity of bankruptcy” creditors do become the beneficiaries of fiduciary duties.[47]

On the contrary, under English law as another representative of a common law jurisdiction, the statute expressly prescribes that no fiduciary duties will be owned by directors to creditors, even if the company is insolvent or close to insolvency.[48] However, directors would be obliged to take into account the interests of creditors when making business decisions.[49]

[43] *Id*. at 787, 789.
[44] *Id*.
[45] Stephen R. McDonnell, *Geyer v. Ingersoll Publications Co.: Insolvency Shifts Directors' Burden from Shareholders to Creditors*, 19 DEL. J. CORP. L. 177, 210 (1994).
[46] J. William Callison, *Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities Is Incorrect as a Matter of Theory and Practice*, 1 J. BUS. & TECH. L. 431, 449 (2007).
[47] MARCUS LUTTER ED., LEGAL CAPITAL IN EUROPE 681 (2006).
[48] STAFFORD & RICHIE, *supra* note 28, at 84.
[49] *Id*.

The reasoning of the Supreme Court of Delaware in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla* provides for an additional point of controversy of the application of directors' fiduciary duties to the financially distressed companies – whether the creditors of an insolvent corporation, or that in the "zone of insolvency", have the right to bring a direct action against the directors, as opposed to the derivative actions (alleging only the harm to the corporation itself).[50] The court tackled this issue by holding that "[t]he creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors".[51] The rationale underlying such holding is that:

> When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.[52]

Thus, this decision eliminates the possibility of creditors to question the decisions of the directors directly and seems to contradict the aforementioned court practice on the shift of fiduciary duties in case of insolvency. Although there has been a number of other court decisions in support of the directors' fiduciary duties owed to the creditors in case of the company's insolvency[53], some commentators argue against the recognition of "zone of insolvency concept" as well. As Stephen M. Bainbridge puts forth, "[t]he zone debate is much

[50] North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 (Del.Supr., 2007).
[51] *Id*. at 94.
[52] *Id*. at 102.
[53] *See, e.g.*, Civ A. No. 12150, 1991 WL 277 613 (Del. Ch. Dec. 30, 1991).

ado about nothing or, perhaps more precisely, about very little" due to the recognition of business judgment rule, which will preclude the judicial review of business decisions prior to the insolvency.[54] In sum, although shift of the directors' fiduciary duties to the company's creditors has been recognized, the exact moment when the creditors come into play is debatable.

In certain situations, third parties may also become the beneficiaries of the directors' fiduciary duties. In *Francis v. United Jersey Bank* the court pointed out that "[w]ith certain corporations, however, directors are seemed to owe a duty to creditors and other third parties even when the corporation is solvent."[55] The case involved the director of the reinsurance broker, that is the intermediary whose business is to arrange contracts between the ceding company and the reinsurer. Based on the peculiar features of the reinsurance industry, the court concluded that third parties indeed had the right to rely on the directors' fiduciary duties.[56] Therefore, third parties (*e.g.* clients in the mentioned case) become the beneficiaries of the director's fiduciary duties only in exceptional situations based on the specific characteristics of the business activity of the company.

1.3. The overview of fiduciary duties in Delaware and Ukraine

The exact scope of directors' fiduciary duties in Delaware has been discussed both in court practice and scholarly materials. While one of the most popular approach on this matter has been the recognition of two components: the duty of care and loyalty, the recent trend is to recognize the "triad" of the directors' fiduciary duties. As was articulated in *Cede v. Technicor* case, to rebut the business judgment rule "a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of

[54] Stephen M. Bainbridge, *Much Ado about Little - Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 368 (2007).
[55] Francis v. United Jersey Bank, 432 A.2d 814, 824, 87 N.J. 15, 36 (N.J., 1981).
[56] *Id*.

the triads of their fiduciary duty—good faith, loyalty or due care."[57] *In re the Walt Disney* case provides the good overview of why the duty of the good faith shall be considered as having the same footing as the duties of care and loyalty.[58] As was mentioned by Melvin A. Eisenberg, "the explicit recognition of the duty of good faith in recent Delaware cases shines a spotlight on that duty…" irrespective of the fact that it remains quite challenging to separate the meaning of such duty from those enshrined in due care and loyalty.[59]

Apart from this, there are several other theories as to the scope of the directors' fiduciary duties in Delaware law. For example, Professor Bernard S. Black proposes the four-pronged system of duties: loyalty, care, disclosure and extra care when selling company.[60] On the contrary, William M. Lafferty, Lisa A. Schmidt, and Donald J. Wolfe, Jr. refer to the duties of care and loyalty as to "traditional fiduciary duties" while arguing that duties of good faith, confidentiality and disclosure are ancillary duties that are derived from the duties of care and loyalty.[61]

As was noted earlier, this thesis follows more traditional and well recognized approach by analyzing the application of duties of care, loyalty and good faith as elements of the directors' fiduciary duties in Delaware.

As for the scope of fiduciary duties in Ukraine, it is noticeable that one of the idiosyncratic features of Ukrainian corporate governance system is that it does not refer to some duties of directors as "fiduciary". Hence, the meaning and scope of fiduciary duties of Ukrainian companies' directors shall be inferred from the teleological interpretation of

[57] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del.,1993).
[58] In re Walt Disney Co. Derivative Litigation, 906 A.2d 27 (Del.Supr.,2006).
[59] Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 76 (2006).
[60] Bernard S. Black, *The Principal Fiduciary Duties of Boards of Directors*, Presentation at Third Asian Roundtable on Corporate Governance Singapore, 1, 20 (4 April 2001), available at http://www.oecd.org/daf/ca/corporategovernanceprinciples/1872746.pdf.
[61] William M. Lafferty; Lisa A. Schmidt; Donald J. Jr. Wolfe, *A Brief Introduction to the Fiduciary Duties of Directors under Delaware Law*, 116 PENN ST. L. REV. 837, 878 (2012).

Ukrainian legislation. Such an idea can be supported by the view of the Supreme Court of Delaware in *Gatz Properties, LLC v. Auriga Capital Corp*. that "[t]here is no requirement …to use magic words, such as 'entire fairness' or 'fiduciary duties'."[62] Instead, the operative language and the underlying meaning of some provisions shall be taken into account.

Furthermore, as was expressed by the Ukrainian Supreme Court in one case concerning the imposition of liability on the director of an LLC, "[t]he nature of the relationship between a company and its director originates in trust" and, thus, the director may violate his obligations towards the company by different actions, such as "by acting in bad faith beyond boundaries of normal commercial risks, with personal interests or abuse of discretion, in rendering clearly negligent or wasteful decisions".[63] Although this decision does not refer to duties of the director as "fiduciary", it, nevertheless, indirectly indicates that their nature is fiduciary and, moreover, the enumeration of possible actions constituting a breach of directors' obligations clearly resembles the scope of fiduciary duties in Delaware discussed above. Thus, it is reasonable to nominate certain duties that Ukrainian directors owe to LLCs as "fiduciary duties".

Pursuant to Art. 40(1) of the Law of Ukraine "On Limited and Additional Liability Companies" (*hereinafter - the New Law*), the directors of the Ukrainian LLCs are obliged to comply with such duties: (1) to act reasonably; (2) to act in good faith; and (3) to act in the best interests of an LLC.[64] However, the New Law contains other provisions on directors' fiduciary duties as well, such as non-compete obligations (Art.40(5) and Art.45).[65] A thorough examination of the court practice will illustrate that Ukrainian courts do not obey by unified

[62] Gatz Properties, LLC v. Auriga Capital Corp., 59 A.3d 1206, 1213 (Del.Supr.,2012).
[63] The decision of the Supreme Court dated 04 December 2018 in case No. 910/21493/17; http://reyestr.court.gov.ua/Review/78412710 accessed 27 January 2019.
[64] The Law of Ukraine, 'On Limited and Additional Liability Companies' [6 February 2018], No. 2275-VIII, Art. 40 <http://zakon.rada.gov.ua/laws/show/2275-19> accessed 30 December 2018.
[65] *Id*. Art 40, 45.

standards of interpretation of such fiduciary duties and, therefore, their practical application is rather chaotic.

Chapter 1 Conclusion

The first chapter defined the concept of fiduciary relationship and directors' fiduciary duties. Firstly, fiduciary relationship arises when one person (agent) is under a duty to act for the benefit of another person (principal). The features of fiduciary relationships are: the agent's discretionary authority and the principal's dependency and reliance on the agent's conduct. The concept of fiduciary duties is quite ambiguous, but generally is used to refer to the duties of the agent to act in the furtherance of the best interests of the principal without abusing his discretion. Secondly, fiduciary duties originate in equity and trust relationships, which makes it quite challenging to provide the all-embracing definition of fiduciary duties. Thus, this thesis investigates one specific situation involving fiduciary duties – corporate governance within companies. Thirdly, there is an ongoing debate as to the beneficiaries of fiduciary duties. While the list of such beneficiaries may be quite extensive, including companies' creditors and third parties, the most recognized approach is to consider that, under normal circumstances, fiduciary duties are owed to a company and its shareholders. Finally, the scope of fiduciary duties in Delaware is reconcilable with the duties of LLCs directors in Ukraine. The second chapter will focus on the exact meaning and interpretation of such duties.

Chapter 2. Scope of fiduciary duties

The Delaware and Ukrainian legal systems have diametrically opposed approaches to the regulations of directors' fiduciary duties. While in Delaware the main driving force of the interpretation and clarification of fiduciary duties lies within the courts' terrain, Ukraine follows traditional civil law approach of defining all legal concepts in statues. However, given the peculiarities of corporate governance jurisprudence, this chapter focuses both on the statutory and judicial interpretation of fiduciary duties in Delaware and Ukraine. First, the chapter discusses the duties of care, loyalty and good faith in Delaware. Secondly, an overview of the legislative framework and court practice as regards directors' fiduciary duties in Ukraine is provided.

2.1. Duty of care

The duty of care as an important component of the directors' fiduciary duties has been recognized in Delaware for a long time. In short, the duty of care imposes the obligation to be careful and to be informed of all the information available to the director throughout the decision-making process. The meaning of this duty clearly demonstrates that this duty is nothing else that an obligation to exercise a reasonable care during making any business decision. Courts and legislative bodies provided a number of different options to describe the content of the duty of care, among which the most popular remains the variant of "a 'traditional standard' dating back to the nineteenth century requiring the care of an ordinary prudent person under similar circumstances".[66] Section 8.30(b) of the Model Business Corporation Act (*hereinafter - MBCA*), albeit not followed expressly in Delaware, represent more or less common understating of the duty of care within the US:

[66] DENNIS BLOCK ET AL., THE BUSINESS JUDGMENT RULE-FIDUCIARY DUTIES OF CORPORATE DIRECTORS 109 (5d ed. 1998 & Supp. 1998).

> The members of the board of directors or a board committee, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.[67]

It is undisputed that the duty of care necessitates a particular standard of care prior to making a business decision without encroaching on the substance of the decision itself, which is protected by the business judgment rule. As noted by the former Delaware Supreme Court Chief Justice, duty of care "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."[68] The relationships between the business judgment rule and the duty of care will be discussed later in this thesis.[69]

However, until 1985 the duty of care duty "led a normal, humble existence in Delaware law."[70] The landmark decision of the Delaware Supreme Court in *Smith v. Van Gorkom* is considered as being a rule-changer in the development and interpretation of the duty of care. This case articulated a standard that directors must inform themselves "prior to making a business decision, of all material information reasonably available to them…".[71] The case arose out of the approval by the board of directors of Trans Union Corporation (*hereinafter - Trans Union*) the Pritzker merger proposal prepared by Van Gorkom, Trans Union's Chairman and Chief Executive Officer, relying solely on the information presented by Van Gorkom. Hence, the *Van Gorkom* court held that "the directors of Trans Union breached their fiduciary duty to their stockholders (1) by their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger; and (2) by

[67] Model Bus. Corp. Act §8.30 (2016).
[68] E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 398 (1996).
[69] *See infra* Chapter 3 (3.1.1).
[70] Stephen J. Lubben; Alana J. Darnell, *Delaware's Duty of Care*, 31 DEL. J. CORP. L. 589, 590 (2006).
[71] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del.,1985) [*hereinafter Van Gorkom*].

their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer."[72] The case provoked a considerable number of concerns and some legal scholars even argued that "[t]his full-throated version of the duty of care alarmed many and consequently was short-lived."[73]

The legislative response to the developing case practice was the enactment of Section 102(b)(7) of the Delaware General Corporation Law (*hereinafter - DGCL*).[74] The statute sets forth the possibility to eliminate or limit personal monetary liability of the director for the breach of some fiduciary duties, including the duty of care. This legislative provision was perceived positively by the business environment, which successfully utilized the possibility provided by Section 102(b)(7) of the DGCL.[75] The reason for that was the growing fear of the management of the companies to be held personally liable once it is proven that the "standard of care" has not been met. Nevertheless, such provision did not kill the duty of care jurisprudence but rather reshaped it in another direction. As one commentator suggested, although the courts may have developed the jurisprudence based on the non-monetary remedies from the directors for the breach of their duty of care, they were reluctant to do so and they "developed a new law of transactions, built around banner cases such as *Unocal Corp. v. Mesa Petroleum Co.* and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*"[76]

In *Unocal Corp. v. Mesa Petroleum Co.* the board of directors made a decision to effect a self-tender offer when one of its minority shareholders, Mesa, made a hostile tender offer for the company's stock.[77] Unocal case "formulated a new enhanced standard of review designed

[72] *Id*. at 893.
[73] Stephen J. Lubben; Alana J. Darnell, *Delaware's Duty of Care*, 31 DEL. J. CORP. L. 589, 590 (2006).
[74] DEL. CODE ANN. tit. 8, § 102(b)(7) (2005).
[75] *See* Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001) (noting that section 102(b)(7) was enacted following directors and officers' insurance liability crisis and Van Gorkom decision).
[76] Lubben, *supra* note 73, at 590-591.
[77] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del.,1985).

to evaluate board decisions in response to, or in anticipation of, a threat to corporate control".[78] The essence of the courts' reasoning was that the directors are in any case of decision-making entitled to the broad discretion, although the courts would require those directors to meet certain minimum standards in takeover situations. Hence, this case illustrates the new approach as to the review of the directors' decision while not changing the scope of the duty of care itself. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* is the case in which the Delaware Supreme Court again expanded the meaning of the duty of care in situations involving a sale of corporate control. The court held that "when sale of the company becomes inevitable, duty of board of directors changes from preservation of the corporate entity to maximization of the company's value at a sale for the stockholders' benefits."[79] Additionally, the Delaware law knows for the specific techniques of takeover defenses, such as poison pills that are known as shareholder rights plans and act as a complete bar to a takeover as long as a target's board keeps in place, which entail even deeper analysis of the duty of care with an aim to ensure the fairness of the business decision.[80] The aforementioned cases demonstrate that the analysis of the directors' duty of care has become subject to the transaction-specific discussion, while no general standards as to its interpretation have been articulated.[81]

Another important reservation as to the scope of the duty of care is the fact that it comes into play not only prior to making a business decision, but also in the oversight context of discharging the duties of the directors. In this regard the case *Francis v. United Jersey Bank* illustrates that a director who has "never made the slightest effort to discharge any of her responsibilities as a director…" was in breach of the due care and was therefore held personally liable for the debts of the company.[82] Another case in this regard is *Lutz v. Boas*, in which the

[78] Lubben, *supra* note 73, at 601.
[79] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del.,1986).
[80] GORDON & RINGE, *supra* note 22, at 194.
[81] Lubben, *supra* note 73, at 606.
[82] Francis v. United Jersey Bank, 432 A.2d 814, 820, 87 N.J. 15, 27 (N.J., 1981).

court considered actions of non-affiliated directors: “almost automatic approval” to the actions of the company’s founders, they “did not examine the registration statements carefully”; “they did not discuss securities at their meetings or discuss any of the other facts which would have been pertinent to a reasonable discharge of their duties”.[83] The court found that such conduct was grossly negligent, and although the duty of care itself was not touched upon (the case was decided in 1961), it seems like such determinations may be employed in the context of duty of care as well.[84]

Based on the analysis of the application of the duty of care, scholars provide a general overview of some other additional elements of the directors’ due care in corporate governance, among which the reliance standard seems to be the most important. Evidently, directors acting in their capacity as manager are not able to reach reasoned decisions purely on the basis of their knowledge. Usually their decisions are based on the reports and examinations conducted either by insiders (such as employees) or outsiders (such as independent advisors). E. Norman Veasey in this regard noted that “[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.”[85] Even if some duties are delegated, the duty of care imposed on the director will not be automatically discharged – the director would still have to stick to the standard of due care in corporate governance. Reliance and delegation aspects of the duty of care have as well been supported and developed in the Delaware’s court practice.[86]

[83] Lutz v. Boas, 171 A.2d 381, 395, 39 Del.Ch. 585, 609 (Del.Ch. 1961).
[84] *Id*.
[85] E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 406 (1996).
[86] *See, e.g.*, Grimes v. Donald 20 Del. J. Corp. L. 757 (Del. Ch. Jan. 11, 1995), aff’d, 673 A.2d 1207 (Del. 1996) (held that “the board of course may delegate such powers to the officers of the company as in the board’s good faith, informed judgment are appropriate”).

To sum up, the duty of care encompasses the obligations imposed on directors to make decisions and conduct an oversight function on informed basis, while at the same time require them to exercise due care while relying on other information and delegating their duties. However, the exact contours of the duty of care are vague.

The analysis if the duty of care would not be complete without mentioning the consequences of its breach. The liability of the directors may vary from imposing personal monetary to non-monetary liability on them. However, the principle of shareholders' primacy shall be mentioned in this regard – it means that if the shareholders of the company approve the conduct of the director, even if he was in breach of the duty of care, it serves as a protection against future claims against such directors. Such idea was articulated in *In re Wheelabrator Technologies, Inc. Shareholders Litigation*, in which the Court of Chancery of Delaware pointed out that "fully informed shareholder vote approving the merger operated to extinguish shareholders' duty of care claims."[87] However, this principle has a different application when it comes to the waste claims. The Court of Chancery of Delaware provided such analysis on this matter:

> The idea behind this rule is apparently that a transaction that satisfies the high standard of waste constitutes a gift of corporate property and no one should be forced against their will to make a gift of their property. In all events, informed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the basis of waste.[88]

[87] In re Wheelabrator Technologies, Inc. Shareholders Litigation, 663 A.2d 1194, 1996 (Del.Ch.,1995).
[88] Lewis v. Vogelstein, 699 A.2d 327, 335–36 (Del.Ch.,1997).

Consequently, the ratification of the director's conduct in breach of the duty of care may serve as a "safe harbor" against the director's personal liability, except for the waste claims.

2.2. Duty of loyalty

The concept underlying the duty of loyalty is straightforward – the director shall act in the best interests of the company and its shareholders instead of pursuing his own personal interests. The director shall not exploit its own managerial position to the detriment of the company itself. Thus, there are two bedrock principles of the duty of loyalty: (1) the director is prohibited to act with a conflict between his duty and his self-interest; and (2) an unauthorized profit for the director may not arise out of his fiduciary position with a corporation.[89] Although some scholars argue that it is doubtful that directors as agents always seek to maximize their own wealth due to the fact that directors exhibit the typical characteristic of people who routinely act unselfishly, even sacrificing their own payoffs to increase others, it cannot be questioned that the duty of loyalty does not purport to investigate the nature of the directors' conduct, but rather aims to mitigate the risks of abuses.[90] Interestingly, the avoidance of conflict of interests has been directly linked to the ideal of maximization shareholders' value: agency problem is minimized or avoided where the interests of both directors and shareholders are aligned, and directors are paid by results.[91]

Since the Delaware statutes are silent on the scope of this duty, it has also been developed by the court practice as part of triad of fiduciary duties. On the contrary, the MBCA provides a generous guidance as to the elements of the duty of loyalty. For example, Section 8.31(A)(2)(III) provides for the possibility to hold the director liable if "a lack of objectivity due to the director's familial, financial or business relationship with, or a lack of independence

[89] STAFFORD & RICHIE, *supra* note 28, at 102.
[90] GORDON & RINGE, *supra* note 22, at 165.
[91] CHRISTOPHER HODGES, LAW AND CORPORATE BEHAVIOR: INTEGRATING THEORIES OF REGULATION, ENFORCEMENT, COMPLIANCE AND ETHICS 673 (2015).

due to the director's domination or control by, another person having a material interest in the challenged conduct…"[92] can be established, while Section 8.31(A)(2)(V) contains provisions that prevent the director from entering into self-interested transactions (the director may be held personally liable upon "receipt of a financial benefit to which the director was not entitled or any other breach of the director's duties to deal fairly with the corporation and its shareholders that is actionable under applicable law").[93]

The Delaware courts have analyzed the duty of loyalty on numerous occasions and provided a number of points to be taken into account for the interpretation of this duty. The general overview of the ideas underpinning the duty of loyalty was provided in a landmark case G*uth v. Loft*, in which the Supreme Court of Delaware specified that:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[94]

[92] Model Bus. Corp. Act §8.31 (2016).
[93] *Id*.
[94] Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

Thus, as was confirmed later, "the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director…and not shared by the stockholders generally."[95]

Legal scholars have systemized the court practice and pursue the idea that the duty of loyalty has four main elements – the directors generally may not:

1. Cause the corporation to engage in an interested transaction which is not entirely fair to the corporation;
2. Profit from the use of confidential corporate information;
3. Take any action solely or primarily to entrench themselves in office; or
4. Otherwise place benefits to themselves or to affiliated entities ahead of benefits of the corporation.[96]

All the abovementioned elements of the duty of loyalty have been affirmed and explained in the relevant court practice. Essentially, the underlying rationale of requiring the director's loyalty to the company is to prevent the personal interest of the director to impair the decision-making process, which will have consequences for the company itself. In case such conflict between personal and company's interests arises, the director is obliged to disclose it and let the corporation or its shareholders to insulate its effect on the business decision-making. Therefore, the following situations may be considered as involving a personal interest of the company's director:

1. The director is 'beholden' to other parties or so under their influence that his discretion would be compromised;[97]

[95] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).
[96] William M. Lafferty, Lisa A. Schmidt & Donald J. Wolfe, Jr., *A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law*, 116 PENN ST. L. REV. 837, 845 (2012).
[97] In re Primedia Inc. Derivative Litig., 910 A.2d 248, 256-57 (Del. Ch. 2006).

2. The director will receive a benefit that is not shared by the corporation's stockholders as a whole.

The relationship between the duty of loyalty and the business judgment rule have some specific features and will be analyzed further in this thesis. One main thing has to be noted here – once the plaintiff proves that even one of the directors was interested while rendering a business decision, the presumption of business judgment rule is placed under the risk to be lost. This means that the business judgment presumption yields to the rule of undivided loyalty and the whole business decision is to be analyzed with a high degree of scrutiny.[98] In *Bayer v. Beran*, an old case decided by the Supreme Court of the New York County representing a well-settled position throughout the US, the court faced exactly this issue and although the business decision to start a radio advertising campaign seemed reasonable to the corporation, the court scrutinized the whole decision due to the presence of the director's personal interest (the director's wife was employed in the campaign).[99]

The duty of disclosure is another aspect which remains under the debate in the context of loyalty. I believe that it shall be analyzed alongside with the duty of loyalty, since they pursue the same objectives. Nevertheless, a number of commentators consider the duty of disclosure as an independent fiduciary duty claiming that it is applicable in two cases: when shareholders are asked to vote, and when the company faces a conflict of interest transaction.[100] While the first case is out of the scope of this thesis, the second is clearly connected to the fulfillment of the duty of loyalty. Even those commentators that argue for the independent status of the duty of disclosure point out that it has two main objectives: "the disclosure allows

[98] *See* W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1039 (rev. perm. ed. 1975).
[99] Bayer v Beran, 49 N.Y.S.2d 2, 15, (Sup Ct, Apr. 18, 1944).
[100] Bernard S. Black, *The Principal Fiduciary Duties of Boards of Directors*, Presentation at Third Asian Roundtable on Corporate Governance Singapore, 1, 6 (4 April 2001), available at http://www.oecd.org/daf/ca/corporategovernanceprinciples/1872746.pdf

shareholders to sue, claiming a violation of the duty of loyalty…[and] disclosure, without more, will deter some conflict-of-interest transactions from being completed."[101] The full and frank disclosure allows the director to obtain a profit or to enter into any transaction involving the conflict of interests upon obtaining fully informed consent of the company.[102] Moreover, the remedy for the breach of the duty of disclosure is the possibility to bring a duty of loyalty lawsuit, and recover damages.[103] Accordingly, I consider the duty of disclosure as one of the elements of the fiduciary duty of loyalty.

The court practice proves this view – in *Malpiede v. Townson* the court noted that "the board's fiduciary duty of disclosure . . . is not an independent dut[y] but the application in a specific context of the board's fiduciary duties of care, good faith and loyalty".[104] The relationship between the duty of loyalty and the duty of disclosure has been summarized in the US doctrine as follows:

> The fair treatment that a fiduciary owes to his beneficiary includes the obligation not to take for oneself profitable opportunities that come to the beneficiary under certain sets of circumstances. The duty of loyalty includes, on some circumstances, a duty of disclosure. The intentional failure or refusal of a director to disclose to the board defalcation or scheme to defraud the corporation of which he has learned in itself constitutes a wrong unless a recognized privilege against disclosure pertains. In addition, officers and directors must exert all reasonable and lawful efforts to ensure that the corporation is not deprived of any advantage to which it is entitled.[105]

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[101] *Id*.
[102] STAFFORD & RICHIE, *supra* note 28, at 85.
[103] Black, *supra* note 100, at 11.
[104] Malpiede v. Townson, 780 A.2d 1075, 1086 (Del. 2001).
[105] WELCH, EDWARD P. & TUREZYN, ANDREW J., FOLK ON THE DELAWARE GENERAL CORPORATION LAW 83 (2005 ed).

The highly debated *Weinberger case* is a good example as to the importance of the disclosure of the conflict of interests in case of controlled mergers.[106] Since some the directors of a tager corporation were on both sides of a transaction, *i.e.* served as directors in an acquiring corporation as well, they were "required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain".[107] With this in mind, such directors should have disclosed and mitigate their potential conflict of interest to ensure the entire fairness of the cash-out merger. Moreover, the court provided an overview of another aspect of the duty of loyalty – the duty of candor. Under this standard the directors are not only required to abstain from any conduct that may potentially injure the minority shareholders (precludes the director with superior information from misleading shareholders not privy to that information) but must also play an active position in protecting the minority – for example, by disclosing the germane information ("information such as a reasonable shareholder would consider important in deciding whether to sell or retain stock").[108] Thus, the court ruled that when the directors are acting in dual capacities, they owe fiduciary duties to both corporations, , one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations.[109]

In summary, the fiduciary duty of loyalty assumes the absence of the director's conflict of interest while making business decisions. Equally important, when such conflict arises the duty of loyalty requires the disclosure from the director.

2.3. Duty of good faith

The existence of duty of good faith as a separate fiduciary duty in Delaware law has been a subject to a debate for a long time. Myron T. Steele, the former Chief Justice of the Delaware

[106] Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del.,1983).
[107] *Id.*
[108] *Id.*
[109] *Id.*

Supreme Court, refers to this duty as to "arguable, if incompletely defined…" and therefore "the highly enigmatic" fiduciary duty.[110]

The enactment of Section 102(b)(7) of the DGCL brought the discussion on the duty of good faith to a different level – this Section contains an exception that an exculpatory provision of the statute limiting the director's liability would not preclude monetary liability, inter alia, "for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law".[111] Thus, it was necessary to establish the status of such duty of good faith, in other words, whether such exception to Section 102(b)(7) of the DGCL requires the breach of free-standing duty of good faith or such duty is just a part of either duty of care or duty of loyalty.

Within a few years after the enactment of Section 102(b)(7) of the DGCL, the Delaware Supreme Court in *Cede & Co. v. Technicolor* case provided an answer to this query by stating that:

> To rebut the [business judgment] rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care.[112]

However, the Delaware Chancery Court opposed the idea of an independent duty of care by explaining that the Delaware Supreme Court reference to the duty of good faith was just a "fresh way of referring to the 'fundamental duties of care and loyalty'…".[113] Some recent decisions, such as *AmSouth Bancorp. v. Ritter*, also treat the duty of good faith as a part of duty of loyalty by arguing that:

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[110] *See* Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 5 (2007).
[111] DEL. CODE ANN. tit. 8, § 102(b)(7) (2009).
[112] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).
[113] In re Gaylord Container Corp. S'holders Litig., 753 A.2d 462, 475 n.41 (Del. Ch. 2000).

> [T]he obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly.[114]

However, it is believed that the court decision in *In re Walt Disney Co. Derivative Litig.* brought the discussion on the status of the duty of good faith to an abrupt halt.[115] This case involved the dispute over lucrative severance payments that the director of the corporation received when the corporation terminated his employment. The case went through a number of court instances and the final decision of the Delaware Supreme Court affirmed not only the recognition of the freestanding fiduciary duty of good faith, but also clarified the meaning and the scope of this duty. According to the *Disney* court, there are three distinct categories of behavior that may be candidates to the pejorative label of bad faith:

1. So-called "subjective bad faith" - fiduciary conduct motivated by an actual intent to do harm;
2. Lack of due care—fiduciary action taken solely by reason of gross negligence and without any malevolent intent; and
3. Intentional dereliction of duty, a conscious disregard for one's responsibilities.[116]

The existence of the third category, which was extensively discussed by the *Disney* court, undoubtedly proves that the duty of good faith is, first of all, an independent and freestanding fiduciary duty and, secondly, that it can be a ground for imposing a liability in case of its breach. Although the court did not find a violation of the duty of good faith in this case, the theoretical

[114] AmSouth Bancorp. v. Ritter, 911 A.2d 362, 369-70 (Del. 2006).
[115] Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. 457, 467 (2009).
[116] In re Walt Disney Co. Derivative Litigation, 906 A.2d 27, 65-66 (Del.Supr.,2006).

discussion on its meaning and scope remains one of the most helpful guidance in the sphere of good faith application in the Delaware corporate governance.

Interestingly, shortly after the *Disney* decision, the Delaware Supreme Court decided *Stone v. Ritter* case.[117] *Stone* again reordered the spectrum of fiduciary duties by holding that no independent fiduciary duty of good faith exists in Delaware corporate law.[118]

Given that even the commendable courts in Delaware produce quite different court decisions on the duty of good faith, it is logical to agree with Myron T. Steele that the public and the courts will be better served provided that "the Delaware courts should look to the statutes and fill any gaps in the parties' express intent by following the statutory mandate to apply the implied contractual covenant of good faith and fair dealing, rather than the enigmatic 'good faith' fiduciary duty at common law".[119] Indeed, the analysis of the Delaware court practice reveals no unified approach neither as to the meaning of this duty nor as to its standing among other fiduciary duties. As described by Myron T. Steele, this uncertainty may lead to the following results:

> It may well be that using "good faith" as a lens through which judges scrutinize past acts does no more than encourage subjective conclusions in hindsight based upon events never anticipated much less assumed by the parties who initiated the conduct the court must scrutinize. Perhaps courts will conclude that "good faith" is an inutile labeling tool, an insubstantial magic carpet to ride to the right result and not a pronouncement of a standard of conduct that leads to predictable results that encourage good governance practices and discourage bad governance practices.

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[117] Stone v. Ritter 911 A.2d 362 (Del. 2006).
[118] *Id*. at 370 (holding that "the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.").
[119] Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 32 (2007).

> Perhaps it will apply only to cases where abject and inexcusable inaction in the face of a known duty to act has been established. Perhaps it will, as one commentator suggests, continue to be used merely as a rhetorical device, albeit on occasion, a useful one.[120]

In summary, the existence and scope of the duty of good faith has always been under the debate in the jurisprudence and legal studies. Although it is applied in a number of cases, there is no uniform approach as to its meaning, which has led some legal scholars to argue against its application.

2.4. Fiduciary duties in Ukraine

2.4.1. The duty of care

Neither the respective provisions of the Civil Code of Ukraine (*hereinafter – the Civil Code*), the predecessors of the New Law, nor the New Law itself mention the duty of care among the obligations imposed on the directors of the companies. While the Civil Code in Art.92(3) contained an obligation to act "reasonably" (*in Ukrainian - розумно*), the New Law has the same "reasonability" duty of conduct.[121] According to the Explanatory Dictionary of the Ukrainian Language, the meaning of this word shall be understood as acting "based on experience, knowledge; practically useful; expedient".[122] In my opinion, this reasonability duty is quite close in meaning to the duty of care imposed by the Delaware law. As the analysis of the Ukrainian court practice will show, such duty of care/reasonability duty is the most used and disputed duty in Ukrainian corporate governance litigation.

[120] *Id*. at 31.
[121] Thsyvilnyi Kodeks Ukrainy [ThK UA] [Civil Code] art. 92 (Ukr.).; The Law of Ukraine, 'On Limited and Additional Liability Companies' [6 February 2018], No. 2275-VIII, Art. 40 <http://zakon.rada.gov.ua/laws/show/2275-19> accessed 30 December 2018.
[122] Dictionary of the Ukrainian language - Academic explanatory dictionary (article on the word 'розумний') available at: http://sum.in.ua/s/rozumnyj.

Although Ukrainian court practice has not articulated a unified approach to the interpretation of the duty of care, some general observations can be made based on its study. A substantial part of the court cases on this matter is devoted to the examination of transactions entered by the directors on behalf of the company and other business decisions made by the directors. Generally, the courts pay attention to the motives of the director to act in a certain way and, based on the evidentiary value of such motives, decide whether the director acted with due care. The following cases demonstrate the application of such approach to the duty of care:

- Decision of the Commercial Court of Odessa region dated 05 June 2016: the director of LLC "Bessarabia-Agro" entered into the contractual relations with LLC "Emax", while in fact the contract was redundant since the respective obligations of the parties under it have never been fulfilled. The court found the director liable for all the damages incurred by LLC "Bessarabia-Agro" based on the improper study of the prospects of concluding such a contract with LLC "Emax";[123]
- Decision of the Commercial Court of Kirovograd region dated 05 May 2017: JSC "Kirovograd-Auto" brought a suit against its director alleging that the company incurred tax liability due to the director's mismanagement. The court decided in favor of the director since the director proved that (1) he has obtained and disclosed to the shareholders all necessary information on the company's tax liabilities; (2) he was keeping all corporate formalities and abiding by tax regulations throughout his service; and (3) the tax inspection which found the company liable was unpredictable and, therefore, its results could not have been mitigated by the director;[124]

[123] The decision of the Commercial Court of Odessa region dated 05 June 2016 in case No. 916/2282/16; http://www.reyestr.court.gov.ua/Review/61912208 accessed 02 January 2019.
[124] The decision of the Commercial Court of Kirovograd region dated 05 May 2017 in case No. 921/2834/10; http://www.reyestr.court.gov.ua/Review/66354074 accessed 02 January 2019.

- Decision of the Commercial Court of the city of Kyiv dated 01 June 2017: LLC with foreign investments "BNH Ukraine" sued its director claiming damages for the burdensome contract entered by the director with LLC "Uviko-LTD". The plaintiff proved that irrespective of the fact that it paid for the goods to be shipped, LLC "Uviko-LTD" never had any intention of shipping the goods. Although the court mentioned that the director was not reasonable during the investigation of this counterparty and the prospective supply contract, it stated that there is no causal link between the director's mismanagement and the damages incurred by the plaintiff.[125]

Another case which illustrates the tensions between the duty of care and the freedom of director's decision-making is about the representation of the foreign investors in Ukrainian court. The Commercial Court of the city of Kyiv on 06 December 2017 rendered a decision in favor of the defendant (the director) based on the analysis of the reasonability of his conduct. The plaintiff – LLC "Trade and logistics complex 'Arctic'" brought a suit against its director claiming that the director caused damages in the amount of UAH 37,812,296.01 (approximately USD 1,378,305.53 as for 24th December 2018) by abandoning the suits on behalf of the company. The thrust of the case was that LLC "Trade and logistics complex 'Arctic'" is an investment vehicle in Ukraine which entered into a number of investment contracts with Ukrainian companies. After some time, Ukrainian companies derelict their duties under such contracts and LLC "Trade and logistics complex 'Arctic'" brought a suit against them to preserve its proprietary rights in certain immovable objects. However, the director of the company unilaterally decided to abandon such suits, which negatively affected financial standing of the plaintiff. The court found for the director in this case and stated that

[125] The decision of the Commercial Court of the city of Kyiv dated 01 June 2017 in case No. 910/2018/17; http://www.reyestr.court.gov.ua/Review/67036143 accessed 02 January 2019.

the director never abused its decision-making powers and provided some reasoning for making such business decision (however, the court never analyzed such reasoning itself).[126]

Yet another case involving the alleged mismanagement of the director of foreign investment company was decided by the Commercial Court of the Kherson region on 20 April 2017.[127] The plaintiff – LLC "Factory of carton packaging 'Pack Systems'" (the ultimate beneficiary owner is a Belize corporation) claimed that ever since the director was appointed, the shareholder of the plaintiff (it was in fact the derivative action initiated by one of the shareholders) suffered a lot of damages because of the business decisions of such director. The problem was that the director was not also constantly deciding to re-invest the profits of the company instead of paying dividends, he also decided to purchase a land from another shareholder of the plaintiff without discussing this matters with all shareholders and, moreover, he was refusing the shareholder's right to information about the company. In my view, this case could have been analyzed as a typical duty of care case (quite similar to the case which discussed the reasonability of certain decisions when it comes to the distribution of profits – Kamin v. American Express Company[128]). Nevertheless, the court abstained from the scrutiny of any of the due care/reasonability standards and instead stated that the plaintiff did not meet the burden of proof regarding the conduct of director and the damages it may have caused. The reasoning of the court in this case is not informative at all since it just recites some statutory provisions, while the facts of the case are, in my view, quite intellectually stimulating.

The two last cases discussed above strike an eye by highlighting the importance of clear regulations on corporate governance when it comes to the rise of foreign ownership of

[126] The decision of the Commercial Court of the city of Kyiv on 06 December 2017 in case No. 910/15206/16; http://www.reyestr.court.gov.ua/Review/70892520 accessed 02 January 2019.
[127] The decision of the Commercial Court of the Kherson region on 20 April 2017 in case No. 923/1315/16; http://www.reyestr.court.gov.ua/Review/66138319 accessed 02 January 2019.
[128] Kamin v American Exp. Co., 383 N.Y.S.2d 807 (Sup Ct, Mar. 17, 1976).

Ukrainian companies. As stressed by Merritt B. Fox, there is a considerable evidence that a company that displays better corporate governance attracts more foreign investors, and, more importantly, this "better corporate governance" can be linked either to effective corporate and disclosure laws of a home country or to the company's individual actions.[129] In other words, when the country fails to provide strong corporate and securities law, it is up to the company itself to undertake the best efforts to improve governance and disclosure. As will be discussed later, one of the examples in this regard may be the limitation of fiduciary duties by various agreements. [130]

Although all the abovementioned court decisions provide for rather scarce arguments on the duty of care (which is typical for the formalistic approach of Ukrainian judges), it is undisputed that they discuss or should discuss the standard of "obtaining all the material information" prior to making a business decision. The fact that the courts refrain from referring to the duty of care does not eradicate the need to analyze such corporate governance disputes from the duty of care/reasonability obligation prospective. However, one important reservation shall be made in this respect – almost all cases relating to the dispute on the director's business decisions are decided in favor of the director once he proves (or just mentions) that he had some reasons to act so prior to the decision – the courts do not analyze such reasons themselves. Such an approach is radically different from those employed by the Delaware courts, which usually engage in long and interesting discussions offering "lucid opinions which are instructive for corporate lawyers and hence also for the whole US corporate world"[131] as to whether the standard of due care was abided by in concrete circumstances.

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[129] GORDON & RINGE, *supra* note 22, at 819.
[130] *See infra* Chapter 3 (3.2.1).
[131] Calkoen, *supra* note 13, at 217.

Since Ukraine is a civil law jurisdiction, the court decisions are not regarded as precedents. This, in turn, means that the courts may continue not to analyze the duty of care imposed on the directors of the companies as long as this is not provided for by the respective legislation.[132] Thus, the first step of the recognition of the duty of care would be its explicit enumeration in a statute, which would enable the progress in the court practice.

2.4.2. The duty of loyalty

The duty of loyalty was not explicitly regulated prior to the adoption of the New Law – the Civil Code contained only one general provision that the representative of a legal entity must act "in the interests of the legal entity, in good faith, reasonably and within the scope of his authority" (Art. 92(3) of the Civil Code).[133] Apart from standard disputes on the confidentiality obligations of the directors, Ukrainian court register reveals only one decision in which the director's loyalty was indirectly touched upon – the Commercial Court of Kherson region decided a case in which the director did not keep corporate formalities while approving a vacation period for himself (no documents proving the reason for such vacation were given to the LLC neither prior to the vacations nor after it).[134] The court applied labor law and decided that the director was not in breach of his loyalty obligations because the LLC could not prove his intention to cause harm to the LLC. Evidently, the necessity to prove an "intention to cause harm to an LLC" represents a high threshold to hold that a director was in breach of his loyalty obligation.

Thus, the jurisprudence on the duty of loyalty has not been developed in Ukraine. However, the New Law introduces a drastic change in this respect – several provisions on the

[132] *See, e.g.*, JULIAN MAITLAND-WALKER, GUIDE TO EUROPEAN COMPANY LAWS 380 (1997) (as to the duties/powers of the boards of directors in the Netherlands).
[133] Thyvilnyi Kodeks Ukrainy [ThK UA] [Civil Code] art. 92 (Ukr.).
[134] The decision of the Commercial Court of Kherson region dated 06 March 2018 in case No. 923/27/18; http://www.reyestr.court.gov.ua/Review/72730497 accessed 06 January 2019.

directors' loyalty obligations have been adopted. This is not a complete novelty for continental European countries – Germany, Italy, and France all indirectly address the director's duty of loyalty from the perspective of the conflict of interests.[135] As stressed by Klaus J. Hopt, there is an international trend "to be more conscious of and rigorous in the treatment of duty of loyalty violations and conflict of interest situations".[136] Since Ukraine is a civil law country, such new provisions are expected to become a cornerstone of the whole litigation and application of the duty of loyalty.

First of all, Art. 40(5) of the New Law stipulates that the director cannot, unless the general meeting of participants or the supervisory board (if established) decide otherwise, compete with the LLC by:

1. Carrying out business activities as a private entrepreneur in the LLC's field of business;
2. Participating in a general partnership or as a full participant in a limited partnership that conducts the same business as the LLC; or
3. Being a member of the executive body or a supervisory board of another company that conducts the same business as the LLC.[137]

The breach of any of the abovementioned non-compete obligations is a ground for termination of the agreement (contract) with the director without payment of any compensation.[138]

135 FLECKNER & HOPT, *supra* note 7, at 55.
136 *Id*. at 56.
137 The Law of Ukraine, 'On Limited and Additional Liability Companies' [6 February 2018], No. 2275-VIII, Art. 40 <http://zakon.rada.gov.ua/laws/show/2275-19> accessed 30 December 2018.
138 *Id*.

Apart from this, Art.42 of the New Law encompasses the regulation on the conflict of interests between the interests of the LLC and its director. The following general duties of the director can be formulated based on the analysis of this article:

1. To provide the LLC with a list of his affiliates when entering into the position of the director with the LLC;
2. To notify the LLC about any changes to the list of his affiliates within five days after receiving the relevant information;
3. To notify the LLC within two days if a conflict of interest (conflict between the general duty of the director to act reasonable, in good faith and in the best interests of the LLC and private interests of such director or his affiliates) arises.[139]

If the director complies with such obligations, it is up to the LLC to decide on the ways to resolve the possible conflicts of interests. This rule is quite similar to the Delaware practice of disclosure prior to the entering into transaction – once the director notifies the LLC about the possible conflict of interests, the burden of dealing with the questionable transaction shifts from the director to the LLC.

Another interesting aspect of the duty of loyalty with Ukrainian LLCs is the possible prohibition of self-dealing. This means that the LLC's charter (alternative expression for the articles of association) may provide for a specific approval process regarding interested party transactions, which the director should follow before entering into such a transaction. An interested party transaction is any transaction that is executed between the LLC and, among others, the director or his affiliate. For the purposes of this definition and abovementioned Art.42, affiliates are any of the following persons: (i) any legal entity that controls, is controlled by or is under common control of a person, (ii) family members and certain close relatives, or

[139] *Id*. Art. 42.

(iii) individuals and/or family members, if they control a legal entity. However, as pointed out earlier, Art.45 of the New Law stipulates that such regulations on interested party transactions are voluntary and if the LLC's charter is silent on this matter, such default provisions of the New Law are not applicable.[140]

Finally, the subsequent ratification of the conduct of the director, even if it is in breach of non-compete obligations or prohibition on self-dealing, eradicates the need to dispute such conduct. The ratification by the shareholders (Art.46 of the New Law regarding interested party transactions[141]) is, in fact, the safe harbor for Ukrainian directors.

Since the enactment of the New Law, these provisions have not been applied in Ukrainian courts yet. This may demonstrate that they are either redundant and not applied in practice or that they have been utilized in practice but still have not become the subject of the litigation. Given that Ukrainian practitioners consider the introduction of the duty of loyalty regulation as a positive development within Ukrainian LLCs and, thus, the provisions, *inter alia*, on non-compete obligations and prohibition of self-dealing have been included in most updated LLCs' charters.[142] This, in turn, means that the jurisprudence on the duty of care is still yet to shape in the future.

2.4.3. The duty of good faith

Although the obligation of the director to act in a good faith has been a part of Ukrainian corporate law ever since it emerged, neither the legislative nor judiciary authority dared to clarify the meaning of it. Moreover, a thorough analysis of Ukrainian court practice clearly

[140] *Id*. Art. 45.
[141] *Id*. Art. 46.
[142] *See* Aequo law firm, *Law Of Ukraine "On Limited Liability And Additional Liability Companies" – New Possibilities For Business* (18th June 2018), https://aequo.ua/publication/law_news/law_of_ukraine_on_limited_liability_and_additional_liability_companies_new_possibilities_for_business/.

demonstrates that courts tend to avoid the application of good faith in the sphere of corporate governance. Thus, although the New Law in Art.40(1) prescribes the director's duty of good faith, the precise meaning and scope of this duty cannot be established.[143] This is rather a negative tendency, since it may cause concerns as to whether the duty of good faith is at all necessary in corporate governance. In my opinion, the situation with unclear meaning of this duty shall be remedied in order to enhance the clarity and consistency of Ukrainian corporate law.

The only one court decision in which the court of first instance used the duty of the director to act in good faith and in the best interests of the company is the *ex parte* (without the presence of both parties) decision of the Moscow district court of Kharkiv city dated 08 October 2016. In this case the plaintiff – LLC "Press-Centre" sued two individual directors (*hereinafter – separately the First and Second Directors and together Directors*) for the damages caused by their negligent management of the LLC. The plaintiff alleged that the First Director concluded a license agreement with a third party whereby the intellectual rights of the plaintiff were transferred to such third party. As was revealed later, the conclusion of such agreement happened after the First Director was resigned from his position, i.e. he had no actual authority to enter into such transactions. When this was revealed, the Second Director decided to remedy the problems caused by the license agreement by forging its date, so that it would look like as if the agreement was entered during the period of the appointment of the First Director. The court stated that both Directors breached their duties of good faith and acted not in the best interests of the LLC "Press-Centre". Therefore, the First Director and the Second Director were held jointly and personally liable to the plaintiff for all the damages caused by the conclusion

[143] The Law of Ukraine, 'On Limited and Additional Liability Companies' [6 February 2018], No. 2275-VIII, Art. 40 <http://zakon.rada.gov.ua/laws/show/2275-19> accessed 3 January 2019.

of the license agreement.[144] The drawback of this decision is that it does not discuss the meaning neither of the duty of good faith nor the obligation to act in the best interests in the company, which means that these matters remain the subject of speculation. In my view, in this case the duty of good faith may involve the necessity to abstain from the breach of statutory provisions while discharging the duties of directors – *e.g.* not to forge the documents or not to mislead the third party about the representation powers of the director.

Despite the specific situation with the application of the duty of good faith, Ukrainian legal scholars discussed a number of possible interpretations of this duty. As Professor Bodnar proposes, the general meaning of the good faith principle shall be understood as "principle that presupposes conscientious and courteous behavior of the person while discharging his subjective obligations and claiming his subjective rights".[145] Based on this idea, it seems logical to state that one way of the construing the director's good faith obligation is to state that such director must act within the authority conferred to him and without the abuse of such authority. However, when it comes to the analysis of this duty in the context of claiming the rights of the director, no such inference of the meaning of good faith can be made.

Professor Kuznetsova, one of the leading scholars in Ukrainian civil law, boils down the general good faith principle to the following categories:

1. Each party shall act in the way beneficial to the general aim of the relationships (*e.g.* general aim in corporate governance would be the successful managing of the company) while avoiding acts detrimental to such aim;
2. Each party shall refrain from violating the rights of another party (*e.g.* the director shall not violate the rights of the LLC); and

[144] The decision of the Moscow district court of Kharkiv city dated 08 October 2016 in case No. 643/964/13- ц: http://www.reyestr.court.gov.ua/Review/43256657 accessed 7 January 2019.
[145] Bodnar T. V., *Vykonannia dogovirnykh zobovjazan u thyvilnomy pravi* [Fulfillment of the contractual obligations in the civil law] (monography), URINCOM INTER 1, 116 (2005) (Ukr.).

3. Each party shall disclose all the information about the progress in discharging its duties (*e.g.* the director shall be obligated to present all the information about his management upon the request of the LLC/its shareholders).[146]

Such postulates of the duty of good faith are quite straightforward and can be easily applied in the context of corporate governance. Supplementing the idea of Professor Kuznetsova, Professor Prymak argues that the good faith, in any case, shall be interpreted based on the principle of morality and taking into account the overall moral surrounding of the disputed situation.[147] Although at first sight this idea might seem appealing by referring to the roots of good faith, I consider that it is hardly applicable in practice mainly because Ukrainian courts avoid engagement in any theoretical discussions and prefer rather strict application of written law.

All in all, irrespective of different meanings of the duty of good faith proposed by the legal scholars, the meaning and scope of it remains unclear due to the reluctance of the legislative and judiciary authority to clarify them.

Chapter 2 Conclusion

The second chapter determined the most important pillars of directors' fiduciary duties in Delaware and Ukraine. First, it discussed the meaning and interpretation of fiduciary duties in Delaware. The duty of care obliges the director to make decisions and conduct an oversight function on informed basis and requires him to exercise due care while acting in reliance on other sources and delegating his duties. The duty of loyalty prevents the influence of the director's conflict of interest on the decision-making on behalf of the company. While the

[146] Kuznetsova N., *Pryncypy suchasnoho zobovjazalnoho prava Ukrainy* [Principles of the modern contractual law of Ukraine], 4 UKRAINIAN COMMERCIAL LAW 1, 13 (2003) (Ukr.).
[147] Prymak V., *Pryntsyp dobrosovisnosti u konteksti zabezpechennia verkhovenstva prava u vidnosynakh tsyvilno-pravovoi vidpovidalnosti* [Principle of good faith in the context of rule of law application within the civil responsibility relationships], 8 YURYDYCHNA UKRAINA 72, 76 (2012) (Ukr.).

separate existence of the duty of good faith is currently disputed, it is considered to promote the best interest of the company in the director's conduct and prohibits certain bad faith actions.

Second, this chapter characterizes the director's duties in Ukraine based on the relevant legislation and court practice. The concept of the duty of care in Ukraine has been utilized in numerous cases, although courts do not refer to it explicitly. The duty of loyalty was described extensively in the New Law, while its judicial application is scarce. The meaning of the duty of good faith remains largely unclarified, since it is almost never used in the court practice. After discussing the scope of fiduciary duties, the next part of this thesis will focus on the possibility to limit or modify it by various agreements.

Chapter 3. Limitations of fiduciary duties

Since the consequences of the breach of fiduciary duties may lead to the unpredictable extent of the liability, it is extremely important to curve out the ways of fiduciary duties' limitations. For the law practitioners and, even more importantly, for the management of companies the speculations on such limitations have always been a fruitful area of research. This section focuses on two well-recognized ways to limit directors' fiduciary duties: the business judgment rule and the possibility to provide certain limitations by agreements both from the perspectives of Delaware and Ukraine. Due to the paucity of Ukrainian case law and regulations in this area, it is uncertain which avenue for such limitations is pursued by the business environment. However, this chapter compares different theoretical methods for prescribing limitations of fiduciary duties and highlight possible practical hindrances that Ukrainian LLCs may face.

3.1 Delaware approach

3.1.1. The business judgement rule

The business judgment rule is undoubtedly one of the bedrock concepts in the Delaware's corporate governance. The importance of it has led the scholars to claim that "[t]he business judgment rule pervades every aspect of state corporate law, from the review of allegedly negligent decisions by directors, to self-dealing transactions, to board decisions to seek dismissal of shareholder litigation."[148] Indeed, almost every case on corporate governance decided in Delaware involves an application of the business judgement rule, which makes it extremely important to understand its scope. This section will provide a theoretical and practical analysis of such rule and will outline the relationships between the business judgment rule and directors' fiduciary duties.

[148] Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 82, 83 (2004).

In short, the business judgment rule is a doctrine that limits the director's liability by preventing the judicial review of the decision taken by the director on behalf of the corporation. The Delaware courts recognize that "[t]he 'business judgment' rule is a judicial creation that presumes propriety, under certain circumstances, in a board's decision. Viewed defensively, it does not create authority…It is generally used as a defense to an attack on the decision's soundness."[149]

The rationale underlying the business judgment rule is that the directors are supposed to have better expertise when it comes to making the decisions on behalf of the company, while the court's main aim is to provide access to justice and not to substitute the authority to make the business decisions. Ideally, "judges should not (even marginally) question the wisdom of the decision itself".[150] Notably, the court is not and shall not be aware of the market environment in which the company operates and, thus, it would be unwise to delegate the decision-making authority to the court. Generally, corporate law refrains from directing directors in their decision-making, which remains the domain of their own perception and evaluation of risks.[151] The feature of different capacities of the directors and courts has been noted and explained by the doctrine as well:

> [M]anagers who make correct decisions about how much information to acquire are rewarded while those who do not are penalized or disappear. There are no similar mechanisms at work for courts. If judges make bad business decisions, they are not demoted or fired. The much-heralded independence of judges, in other words, although desirable for other reasons, makes judges particularly poor

[149] Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del., 1981).
[150] Calkoen, *supra* note 13, at 217.
[151] FLECKNER & HOPT, *supra* note 7, at 53.

> candidates to make business decisions because it frees them from the contractual and market mechanisms that encourage sound decision making.[152]

The business judgment rule is a presumption that serves two main salutary purposes. First of all, it protects the directors from the intervention of the courts in their decision-making, albeit such protection will depend significantly on the procedural treatment of the rule. The essence of the presumption is that it presupposes that business decisions are taken by loyal (independent) directors with due care (on properly informed basis) and in good faith (with a belief that they are acting in the best interests of the company). Evidently, the business judgment presumption is closely connected to all three fiduciary duties and, more importantly, assumes that all of them were met when the decision was taken. The consequence of this is that if the dispute arises with respect to a decision that has been made by the director, the court's review will be limited only to the extent necessary to determine whether the plaintiff has a proof to overcome the business judgment presumption.[153] If the presumption has not been overcome, then, as described by Dennis Block based on the court practice analysis, the business judgment rule "prohibits the court from going further and examining the merits of the underlying business decision".[154]

The second fundamental objective, which is sometimes underestimated, is favoring the shareholders' decisions to appoint the company's management and to delegate the authority to act on behalf of the company to such managing bodies. For example, the DGCL in Section 141(a) states that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."[155] This provision provides for the

[152] Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1443 (1985).
[153] BLOCK ET AL., *supra* note 66, at 5.
[154] *Id.*
[155] DEL. CODE ANN. TIT. 8, § 141(a) (2016).

default opt-out rule and, thus, management of the company's business in most cases is to be delegated to the board of directors. The board itself is one of the essential legal characteristics of a company, denoting the strategy-setting body vested with centralized administration, which indicates the inclusion of both board and management responsibilities.[156] As William T. Allen notably admits, "strong protection against the risk of judicial second guessing reasonableness of board decisions – such as the business judgment rule - is in the economic best interests of shareholders ex ante."[157] Another telling example is the preservation of the whole governance structure of the company - if the courts were allowed to question the managerial decisions, this would create incentives to the recalcitrant shareholders to litigate. The possible problems arising of this were described by Michael P. Dooley and E. Norman Veasey:

> If stockholders are given too easy access to courts, the effect is to transfer decisionmaking power from the board to the stockholders or, more realistically, to one or a few stockholders whose interests may not coincide with those of the larger body of stockholders. By limiting judicial review of board decisions, the business judgment rule preserves the statutory scheme of centralizing authority in the board of directors. In doing so, it also preserves the value of centralized decisionmaking for the stockholders and protects them against unwarranted interference in that process by one of their number. Although it is customary to think of the business judgment rule as protecting directors from stockholders, it ultimately serves the more important function of protecting stockholders from themselves.[158]

[156] BEATE SJAFJELL, TOWARDS A SUSTAINABLE EUROPEAN COMPANY LAW: A NORMATIVE ANALYSIS OF THE OBJECTIVES OF EU LAW, WITH THE TAKEOVER DIRECTIVE AS A TEST CASE 45 (2009).
[157] Allen, William T., *Modern Corporate Governance and the Erosion of the Business Judgment Rule in Delaware Corporate Law* 12 (Comparative Research in Law & Political Economy. Research Paper No. 6/2008).
[158] Michael P. Dooley; E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 522 (1988).

Such statements demonstrate that the business judgment rule was invented not only to protect the directors, but the shareholders in general. Thus, the rationale behind the business judgment rule can also been viewed as "judicial acknowledgment of a board of directors' managerial prerogatives".[159]

The business judgment rule has its own constitutive elements, which have been identified and clarified by legal scholars in the following way:

1. The presence of a business decision is the first and decisive element of the rule. Evidently, there must be some kind of decision made and, thus, in the words of *Rales v. Blasband* court, "[w]here there is no conscious decision by directors to act or refrain from acting, the business judgment rule has no application."[160] Apart from this, the decision must concern the business affairs of the company;
2. The director must be disinterested and independent so that the decision is not influenced by his personal interests;
3. The director must exercise the due care, that is, to act on informed basis in a manner that an ordinary prudent person in a comparable situation would act;
4. The director must act in good faith by having a belief that the decision is in the best interests of the company; and
5. The director must not abuse its discretion.[161]

Although it is questionable whether the abovementioned points should be regarded as elements of the business judgment rule or rather as standards of prudent business decisions, it is undisputable that to rebut the protection provided by the rule, the plaintiff has to prove the absence of either of these five elements. As described by Klaus J. Hopt, the business judgment

[159] BLOCK ET AL., *supra* note 66, at 12.
[160] Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993).
[161] *See* BLOCK ET AL., *supra* note 66, at 39-84.

rule gives directors a “safe haven from liability”, provided that all its elements of were fully observed.[162]

Even though the existence of the business judgment rule is generally acknowledged, its juridical nature remains to be controversial. There are two competing concepts in this respect: one treats the business judgment rules as a standard of review, while the other considers it as an abstention doctrine. The consideration of such concepts is useful from the perspective of possibility to borrow them and implement in practice in other countries, especially in civil law countries.

Under the standard of review approach, “the business judgment rule […] entails some objective review of the quality of the board's decision, however limited.”[163] From the pure procedural point of view, the standard of review entails that the courts shall apply some kind of the substantive test to review the business decision before the imposition of liability.[164] One of the practical examples of such approach is the court’s reasoning in *Cede & Co. v. Technicolor, Inc.*[165] Analyzing the application of the standard of review in this case, Professor Stephen M. Bainbridge articulates that the *Cede* court established the process requirements as to the duty of care, which should have been applied prior to the merger approval, and used such requirements for the judicial review of the business decision.[166] By doing so, the Supreme Court of Delaware explicitly undertook some objective review on the merits of the board’s decision, which cannot be observed under the abstention doctrine.

[162] FLECKNER & HOPT, *supra* note 7, at 57.
[163] Bainbridge, *supra* note 148, at 91.
[164] Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 437 (1993).
[165] Cede & Co. v. Technicolor, Inc., 13 DEL. J. CORP. L. 225, 231 (Del. Ch. Jan. 13, 1987).
[166] Bainbridge, *supra* note 148, at 93.

The abstention doctrine treats the business judgment rule as a negative presumption on judicial review of directors' decisions. Thus, the courts shall refrain from considering the merits and the substance of directors' decision, unless claimant rebuts such presumption. One of the best examples of such approach is *Shlensky v. Wrigley* case – "one of corporate law's hoariest chestnuts".[167] In this case the court clearly avoided the examination of the business decision not to install night lights on the baseball Wrigley Field in Chicago, which, in the view of the plaintiff, caused losses to the company.[168] The main argument of the court was that "[i]n a purely business corporation … the authority of the directors in the conduct of the business of the corporation must be regarded as absolute when they act within the law, and the court is without authority to substitute its judgment for that of the directors."[169]

Therefore, the court established a standard that the courts shall not second-guess the business decisions, unless there is a clear indication of such necessity. Such principle has been followed in a number of cases later throughout the US, such as *Kamin v. American Express Co.*, in which the court refused to review the decision on the payment of dividends by arguing that "[t]he directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions which will have an impact of on profits, market prices, competitive situations, or tax advantages."[170]

It is clear that there is a conceptual difference between treatment of the business judgment rule as the standard of review and the abstention doctrine, which lies in the manner in which the court reviews the business decision. Although there is no consensus as to what approach shall prevail, from corporate governance prospective the doctrine of abstention is more

[167] Bainbridge, *supra* note 148, at 95.
[168] Shlensky v. Wrigley, 237 N.E.2d 776, 779, 95 Ill.App.2d 173, 176 (Ill.App. 1968).
[169] *Id*. at 179.
[170] Kamin v American Exp. Co., 383 N.Y.S.2d 807, 810–11 (Sup Ct, Mar. 17, 1976).

advantageous to the management of the company. The positive characteristics of the abstention doctrine have been formulated by the scholars as follows:

> If the business judgment rule is framed as an abstention doctrine, however, judicial review is more likely to be the exception rather than the rule. The court begins with a presumption against review. It then reviews the facts to determine not the quality of the decision, but rather whether the decision-making process was tainted by self-dealing and the like.[171]

One of the recent results in dealing with the tensions between the standard of review and the abstention doctrine is the emergence of the third approach – the immunity doctrine. Such approach, albeit close in meaning to the abstention doctrine, provides for the recognition of directors' decision-making as an immunity guaranteed by the state.[172]

Duty of care

The duty of care, which provides for certain reasonableness standard of directors' decisions, is considerably constrained by the business judgment rule. As was noted earlier, the duty of care in its literal meaning is connected both to the process-oriented and quality standards of the business decisions. On the other hand, the business judgment rule, by creating the presumption of the appropriateness of the decision, limits the scope of the duty of care only to its procedural part. Hence, "because application of the business judgment rule prevents the imposition of liability, and the care element of the rule is solely process, the duty of care in the decision-making context is *process due care alone*."[173]

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[171] Bainbridge, *supra* note 148, at 128.
[172] Lori McMillan, *The Business Judgment Rule as an Immunity Doctrine*, 4 WM. & MARY BUS. L. REV. 521, 574 (2013), https://scholarship.law.wm.edu/wmblr/vol4/iss2/5.
[173] Charles Hansen, *The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project*, 48 BUS. LAW. 1355, 1356 (1992) (emphasis added).

Smith v. Van Gorkom, which has already been cited earlier[174], is the landmark decision which established this process-oriented meaning of the duty of care. The court noted that the directors did not adequately inform themselves prior to making a decision and because of this violation of the due process they were held liable and the case was remanded for further proceedings.[175] This approach to construe the duty of care only with due process standards because of the existence of the business judgment rule was later followed by Delaware courts – for example, in *Citron v. Fairchild Camera and Instrument Corp.*, the Supreme Court of Delaware argued that "[i]n our case law since *Van Gorkom*, our due care examination has focused on a board's decision-making process. We look for evidence as to whether a board has acted in a deliberate and knowledgeable way in identifying and exploring alternatives."[176]

The business judgment rule is indeed the main reason why the interpretation of the duty of care in corporate law is completely different from its meaning in tort law. While "in tort law the standard is results-oriented … in corporate law the standard is met if directors took appropriate steps to become informed before making a decision."[177]

As was summarized by the legal commentators, a plaintiff who seeks to prove the breach of the duty of care must first establish sufficient facts to overcome the business judgment presumption that the directors acted with due care and only after this, if the plaintiff is successful, the burden of proof shifts to the directors to prove that they acted with due care.[178]

However, the business judgment rule protects directors' decisions provided that the decision has in fact been made. This means that in the context of non-decision-making process, the duty of care will necessitate the judicial review not only on the procedural aspects, but also

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[174] *See supra* note 71.
[175] Van Gorkom, *supra* note 71 at 858.
[176] Citron v. Fairchild Camera and Instrument Corp., 569 A.2d 53, 66 (Del.,1989).
[177] Hansen, *supra* note 173, at 1358.
[178] BLOCK ET AL., *supra* note 66, at 110-111.

on the merits of the decision. A great example is *Francis v. United Jersey Bank* case[179], in which the business judgment rule was not applied given that the director (Mrs. Pritchard) never exercised its business judgment within the company's corporate affairs.[180] Therefore, the New Jersey Supreme Court held itself entitled to the scrutiny of the director's conduct and held her liable for the damages caused to the company.[181] Although this decision is not relevant to the Delaware law directly, it is a telling example of the different application of the business judgment rule when no business decision has been made.

Duty of loyalty

The interrelation between the business judgment rule and the duty of loyalty is similar to that between business judgment rule and the duty of care - the business judgment presumption will assume the presence of the duty of loyalty while the business decision was taken. Thus, the plaintiff must prove at first that the director was either interested in the transaction or lacked independence to overcome the presumption. However, unlike the process-oriented characteristic of the duty of care, the scope of the duty of loyalty has not been influenced by the business judgment rule.

The thorough analysis of the case law demonstrates that the breach of the duty of loyalty is the most effective and promising way to rebut the protection of the business judgment rule. This was noted by a number of commentators, for example, Ralph A. Peeples rightly points out that "[t]he most common rebuttal to a defendant's reliance on the business judgment rule is an allegation of lack of independence, usually a claim that the defendant had an "interest" in the transaction."[182] As the decision in *Aronson v. Lewis* demonstrates, the presence of "interest"

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[179] Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).
[180] *Id*. at 820
[181] *Id*.
[182] RALPH A. PEEPLES, *Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME LAW REVIEW 456, 461 (1985).

of the board of directors may be a prerequisite for a derivative plaintiff's claim that demand on the board of directors (one of the procedural requirements to start a derivative litigation) should be excused as futile.[183]

The court practice has definitely elaborated the application of the breach of the duty of loyalty in the sphere of derivative litigation. Overall, the shareholders in derivative litigation try to "attack directors … engaging in conflict of interest transactions with the corporation or taking a corporate opportunity belonging to the corporation".[184] One of the most common examples is the application of the duty of loyalty in claiming to excuse the demand as futile in order not to apply the protection of the business judgment rule. The options backdating scandal can serve as another notorious example of the interrelation between the duty of loyalty and directors' business judgment. This scandal was based on the events whereby many large corporations provided their executives with options to buy stocks on the backdated terms and dates, resulting in the insiders' unjust benefit obtained from their companies.[185] Thus, the violation of the duty of loyalty has become the most widespread way of rebutting the business judgment presumption.

Good faith

Since the observance of the duty of good faith is presumed under the business judgment rule, the plaintiff also has to present evidence as to the breach of this fiduciary obligation sufficient to overcome the presumption. As rightly pointed out by Willem J.L. Calkoen citing *Citigroup* case, "Delaware law does not permit that kind of judicial second-guessing of director' business decisions — even decisions that turn out to have catastrophic results — as long as

[183] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
[184] GORDON & RINGE, *supra* note 22, at 910.
[185] *Id*.

those decisions were not made in bad faith."[186] However, the relationship between the duty of good faith and the business judgment rule has no peculiar features.

In summary, the business judgment rule is a concept that penetrates the whole system of corporate governance within companies incorporated in Delaware and affects directly the legal standing of the directors and shareholders. The purpose of having such rule is to achieve the compromise between two competing values – authority (the need to preserve the discretionary nature of the director's powers) and accountability (the need to prevent and to remedy improper conduct of decision makers).[187] However, the existence of the business judgment rule has also been criticized by legal scholars. Kent Greenfield considers it as one of the main obstacles to the effective corporate governance by referring to it as "one of corporate law's persistent paradoxes" with an explanation that "the law imposes strict fiduciary duties in company management but … courts rarely enforce them because of the deference embodied in the business judgment rule".[188]

3.1.2. Limitation of fiduciary duties by agreements

The regulation and the court practice of waiving and limiting certain directors' fiduciary duties is radically different for LLCs and corporations. This subsection provides general conceptual overview of the possibilities to limit fiduciary duties enshrined in Delaware law.

As for the corporations, the Delaware legislation contains only one provision stipulating the possibility to include in the certificate of incorporation:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability

[186] Calkoen, *supra* note 13, at 220.
[187] Adina Ponta, *The business judgement rule – approach and application,* 2 JURIDICAL TRIBUNE 25,28 (2015).
[188] KENT GREENFIELD, THE FAILURE OF CORPORATE LAW 218 (2007).

of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective.[189]

Hence, the shareholders of a corporation are free to include the provision limiting the director's liability for the breach of fiduciary duties, subject to the restrictions mentioned above – *e.g.*, the duty of loyalty cannot be limited, the director may not act in bad faith to use this limitation. This Section has been popularity referred to as "a source of inspiration" for legal systems that seek the improvement of corporate law, mainly because it provides for a general exculpatory provision coupled with a "baseline" between "good faith directors" and those who should not be afforded the protection of this exculpatory provision.[190] Thus, Section 102(b)(7) allows for a particular form of the discharge from directors' liability provided that good faith requirement is met. The Delaware Supreme Court noted in *Stone v. Ritter*, "a director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest".[191] Therefore, the standard of the good faith in the application of Section 102(b)(7) is tantamount to a director's subjective good faith.[192]

Apparently, the case law has shaped the application of this provision by adding some other restrictions. In *Emerald Partners v. Berlin*, the court explicitly recognized that "[t]he statutory enactment of Section 102(b)(7) was a logical corollary to the common law principles

[189] DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).
[190] Ngoc Thy Pham, Directors' Liability: A Legal and Empirical Study 107 (Mar. 10, 2017) (unpublished Doctoral thesis, the Erasmus University Rotterdam) (on file with the Law Library of the University of Amsterdam).
[191] Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).
[192] Pham, *supra note* 190, at 135.

of the business judgment rule" and noted that "although a Section 102(b)(7) charter provision may provide exculpation for directors against the payment of monetary damages that is attributed exclusively to violating the duty of care, even in a transaction that requires the entire fairness review standard *ab initio*, it cannot eliminate an entire fairness analysis by the [c]ourt".[193] Thus, even though the duty of care may be eliminated by the shareholders, courts are still entitled to review the business decision using the duty of care standard (entire fairness standard) to establish the breach of duty of loyalty or good faith.

As for the duty of loyalty, in *Sutherland v. Sutherland* the exculpatory charter provision regarding directors' self-dealing transactions was considered to be unenforceable since it was contrary to the laws of Delaware and against public policy.[194] Importantly, although the Delaware corporate statute empowers a corporation to renounce corporate opportunities, that provision does not have an effect of the complete relief from the duty of loyalty. The relevant provision is formulated as follows:

> Every corporation created under this chapter shall have power to [*inter alia*] [r]enounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or more of its officers, directors or stockholders.[195]

The adoption of such provision was a drastic step in the Delaware corporate law – it allows to determine the scope of the duty of loyalty by renouncing its component of corporate opportunities. The doctrine of corporate opportunities "forbids a person who stands in a

[193] Emerald Partners v. Berlin, 787 A.2d 85, 91-93 (Del.Supr.,2001).
[194] Sutherland v. Sutherland, 2009 WL 857468, at *4 (Del.Ch.,2009).
[195] Del. Code Ann. tit. 8, § 122(17) (2017).

fiduciary relationship to a corporation to take for himself a business opportunity to which the corporation is equitably entitled" and in corporate governance context it entails that the director must first offer the opportunity to the company before taking it himself.[196] While the duty of loyalty in corporations was regarded as "immutable" and mandatory in nature for a long time[197], such provision means that Delaware "ignited an unprecedented, multistate experiment in empowering corporations to waive the [corporate opportunities doctrine]— an integral part of the fiduciary duty of loyalty."[198] The empirical study of such corporate opportunities waivers shows that "public companies have shown a significant appetite for enacting waivers and that their newfound contractual freedom has not been received negatively among investors".[199]

In sum, while the limitation of directors' fiduciary duties (through the limitation of director's liability) is possible in corporations, the extent and scope of such limitations shall be in complete adherence to the statutory regulations.

As for limited liability companies, the pertinent provisions of the Delaware Limited Liability Company Act (*hereinafter – the Delaware LLC Act*) permit not only to modify the liability for the breach of fiduciary duties, but to abolish them in general:

> (c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited

[196] David Clayton Carrad, *The Corporate Opportunity Doctrine in Delaware: A Guide to Corporate Planning and Anticipatory Defensive Measures*, 2 DEL. J. CORP. L. 1, 2 (1977).
[197] Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 496 n.16 (2002).
[198] Gabriel Rauterberg; Eric Talley, *Contracting out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1152 (2017).
[199] *Id*.

liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

(d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement for breach of fiduciary duty for the member's or manager's or other person's good faith reliance on the provisions of the limited liability company agreement.[200]

As can be seen from those provisions, the LLC operating agreement has a wide leeway in limiting and eliminating fiduciary duties, and the restrictions on such freedom of contract are minor. As rightly pointed out by the Court of Chancery of Delaware, "[w]hile somewhat analogous to 8 Del. C. § 102(b)(7), which authorizes a corporation to adopt provisions limiting liability for a director's breach of the duty of care, Section 18-1101(e) [of the Delaware LLC Act] goes further by allowing broad exculpation of all liabilities for breach of fiduciary duties-including the duty of loyalty."[201] The conceptual difference between limiting only the liability for the breach of fiduciary duties and the fiduciary duties themselves lies within remedial context – when the fiduciary duty is limited, the plaintiff cannot seek any remedy based on such breach, while if only the monetary liability is limited, the plaintiff can, nevertheless, seek equitable remedies.

The best illustrative case in this respect is *Fisk Ventures*, in which Dr. Segal made claims against Fisk Ventures for breach of contract and fiduciary duties while the LLC operating

[200] Del. Code Ann. tit. 6, § 18-1101(e) (2001).
[201] Kelly v. Blum, 2010 WL 629850, at *11 (Del.Ch.,2010)

agreement waived any fiduciary duties.[202] The Court of Chancery of Delaware affirmed that an LLC operating agreement "flatly stating that members have no duties other than those expressly articulated in the [a]greement" was binding on the court and Dr. Segal's claim was dismissed.[203] As can be noted from the formulation of Section 18-1101(e) of the Delaware LLC Act, there is one substantial restriction to the limitation of fiduciary duties - the implied contractual covenant of good faith and fair dealing cannot be eliminated. This is an important protection against bad faith actions which has been explained by the Supreme Court of Delaware by tracing the contractual nature of an LLC as follows:

> The implied covenant of good faith and fair dealing involves a "cautious enterprise," inferring contractual terms to handle developments or contractual gaps that the asserting party pleads neither party anticipated. "[O]ne generally cannot base a claim for breach of the implied covenant on conduct authorized by the agreement." We will only imply contract terms when the party asserting the implied covenant proves that the other party has acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected.[204]

Although it is well settled that the LLC may waive fiduciary duties, the academic debate as to its policy dimensions has continued. Myron T. Steele argues that the debate should be concentrated on the existence of default fiduciary duties, which "violate the strong policy favoring freedom of contract enunciated by Delaware's legislature."[205] Without diving into the discussion on the default fiduciary duties in Delaware LLCs, one thing has to be noted – the statutory amendment (addition of Section 18-1101(e) to the Delaware LLC Act) just clarified

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[202] Fisk Ventures, L.L.C. v. Segal, No. 3017-CC, 2008 WL 1961156 at 6 (Del. Ch. May 7, 2008).
[203] *Id*. at 11.
[204] Nemec v. Shrader, 991 A.2d 1120, 1125–26 (Del.Supr.,2010).
[205] Myron T. Steele, *Freedom Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 223 (2009).

that common law fiduciary duties could be expanded, restricted, or eliminated in an LLC agreement and by doing so, the strong public policy to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements was affirmed.[206]

Accordingly, the underling rationale as to why there is such difference regarding the limitations of fiduciary duties is connected to the different treatment of LLCs and corporations – LLC is entitled to a greater extent of flexibility as it is an alternative unincorporated business entity. In its very nature an LLC in Delaware, and throughout the US, is quite unique as it combines certain features of corporations and partnerships. LLCs have the ability to protect their managers against liability for certain breaches of fiduciary duties if the parties desire. On the contrary, the current corporate scheme of the DGCL allows for the elimination of personal monetary liability of a director to the corporation or its stockholders.[207] The possibility to limit directors' fiduciary duties in Delaware is an important development and as H. Justin Pace maintains, the waivers of fiduciary duties in LLCs make "business environment more conducive to investment by entrepreneurs in new ventures by providing certainty and flexibility".[208]

3.2. Ukrainian approach

3.2.1. Existence of the business judgment rule

Ukrainian corporate legislation does not contain any business judgment rule or any other provision that shields directors' decision-making from the courts' interference. This was confirmed by the practitioners who noted that "[t]he [b]usiness [j]udgment [r]ule is not

[206] *Id*. at 226.
[207] Ann E. Conaway, *Lessons to Be Learned: How the Policy of Freedom to Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law*, 33 DEL. J. CORP. L. 789, 818 (2008).
[208] H. Justin Pace, *Contracting out of Fiduciary Duties in LLCs: Delaware Will Lead, but Will Anyone Follow*, 16 NEV. L.J. 1085, 1143 (2016).

expressly defined by Ukrainian law" and, thus, the general rules on liability are applicable to directors of LLCs.[209] The only relevant provisions in this context are Articles 40(2) and 40(3) of the New Law, which are formulated as follows:

> Members of the supervisory board and the executive body shall be liable to the company for any damages caused to it by their guilty acts or negligence.
>
> Any member of the supervisory board and any member of the executive body shall be released from liability if he proves that the damage was not caused by his fault.[210]

Evidently, the first cited provision is a general rule on the imposition of liability, which is not quite informative, while the second provision prescribes the way in which the burden of proof in disputes is distributed – it is imposed on the director. Thus, it is for the director to prove that he acted in accordance with his duties when his decisions are disputed in courts. This is a striking difference from the Delaware's approach – the director is not protected by any presumptions and, thus, the business judgment rule is, in fact, completely disregarded.

The drafting history of the New Law reveals some inconsistencies as to the explanation of the establishment of such harsh provision on directors' liability. On the one hand, unofficial explanatory note to the New Law prepared by the major lawyers' non-governmental organization in Ukraine, in which many of the deputies-drafters of the New Law participate, contains a clear reference to the business judgment rule.[211] Furthermore, this explanatory note provides for the completely opposite distribution of the burden of proof – it was supposed to be to the plaintiff to prove the guilt or negligence of the director to impose personal liability on

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[209] ALESSANDRO VARRENTI ET AL., COMPANY DIRECTORS 496 (2012).
[210] The Law of Ukraine, 'On Limited and Additional Liability Companies' [6 February 2018], No. 2275-VIII, Art. 40 <http://zakon.rada.gov.ua/laws/show/2275-19> accessed 18 January 2019.
[211] *Explanatory note to draft of the Law of Ukraine 'On Limited and Additional Liability Companies'*, All-Ukrainian Public Organization "Ukrainian Bar Association", https://uba.ua/documents/doc/pojasnjuvalna_zapyska.pdf.

him. As explained in the note, the main driving force for such rule was a practice of very strict application of previous rules of the Civil Code, which led to the fact the almost every director and official of LLCs was completely unprotected from liability (due to recognition of presumption of guilt).[212] Such approach was completely substantiated and, moreover, was based on the worldwide practice in the field of corporate governance, including Delaware court practice (explicitly mentioned in this explanatory note).

On the other hand, the Official Explanatory Note to the New Law is radically different from the unofficial one.[213] Not only it does not include any reference to the business judgment rule, it also does not contain any explanations to Articles 40(2) and 40(3) of the New Law. Therefore, it is impossible to guess what was the motivation of the Ukrainian legislator to change the proposed rule on the burden of proof by imposing it on the director. Interestingly, the Official Explanatory Note to the New Law claims that "[w]hen drafting the [New] Law, foreign legal practice was used, in particular … the Delaware General Corporation Law [and] jurisprudence of the United States."[214]

Since the New Law is radically different from the rules of Delaware on the business judgment rule, the business judgment rule was definitely not among those principles that the Ukrainian legislator decided to borrow from Delaware. Undeniably, the intent of the legislature is a complex and multifaceted matter. Each of the many persons involved in framing a particular statute may approach a problem from a variety of different policy objectives and may even take into account political factors or career concerns.[215] As ascribed by many neo-classical economists, the role of the state should stem from the need to correct market imperfections.[216]

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[212] *Id*.
[213] *Explanatory note to draft of the Law of Ukraine 'On Limited and Additional Liability Companies'*, Verkhovna Rada of Ukraine, http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=59093.
[214] *Id*.
[215] S.D. Myers Inc. v Canada, First Partial Award and Separate Opinion, Ad hoc – UNCITRAL Arbitration Rules, 8 ICSID Reps 18, 13 November 2000, para 161.
[216] EJAN MACKAAY, LAW AND ECONOMICS FOR CIVIL LAW SYSTEMS 183 (2013).

However, this situation with a “reversed” burden of proof in corporate governance disputes seems to create other market imperfections instead of curing the existent ones.

Although Ukrainian courts do not have the possibility to use the business judgment rule as a powerful instrument to protect directors’ decisions from the courts’ review, they are willing to do so by using rather scarce and not compelling argumentation. The seminal cases in this respect are those concerning the duty of care – almost in all cases mentioned in 2.4.1. The duty of care Ukrainian courts abstained from second-guessing of directors’ decisions. The following classification summarizes some of the approaches followed by the courts:

- If the director abides by corporate and tax formalities, the court will have no basis to interfere (as was decided in the Decision of the Commercial Court of Kirovograd region dated 05 May 2017[217]); and
- If the director proves that he had some grounds to conduct certain activity (*e.g.* to enter into commercial transaction), the court will not decide on the merits of the plaintiff’s claim to hold the director liable for the damages caused to the corporation (as was decided in the Decision of the Commercial Court of the city of Kyiv dated 01 June 2017[218] and the Decision of the Commercial Court of the city of Kyiv on 06 December 2017[219]).

The most important court decision in this respect is a recent ruling by the Supreme Court (newly reformed institution on the highest level of Ukrainian judicial system), which raises some concerns in that it illustrates not only the willingness of the Supreme Court to recognize fiduciary duties, but also to uphold some form of business judgment rule. The LLC with foreign

[217] The decision of the Commercial Court of Kirovograd region dated 05 May 2017 in case No. 921/2834/10; http://www.reyestr.court.gov.ua/Review/66354074 accessed 02 January 2019.
[218] The decision of the Commercial Court of the city of Kyiv dated 01 June 2017 in case No. 910/2018/17; http://www.reyestr.court.gov.ua/Review/67036143 accessed 02 January 2019.
[219] The decision of the Commercial Court of the city of Kyiv on 06 December 2017 in case No. 910/15206/16; http://www.reyestr.court.gov.ua/Review/70892520 accessed 02 January 2019.

investments "BNH Ukraine" (company engaged in trade in petroleum derived fuels and combustible liquids, chemical products) brought a suit against its former general director (the head of the board of directors) alleging that he breached his obligations towards plaintiff by concluding an additional agreement to the general contract for the supply of petroleum products which resulted in damages in amount of 960,549.71 UAH (approximately 34,570.00 USD as of 27 January 2019).[220] Importantly, the damages to the plaintiff arose out of the fact that the party to such additional agreement never had an intention to fulfill its obligations under it and neither the negotiations, nor the court decision followed by unsuccessful enforcement proceeding could force such party to deliver petroleum products in dispute. The court of first instance and appellate court dismissed the claims against the general director and, consequently, the Supreme Court affirmed such decisions. In the words of the Court,

> The nature of the relationship between a company and its director originates in trust, which is why the unlawful conduct of the director may be represent not only by negligent acts, imposed by constituent documents of the company or by abuse of authority while acting on behalf of the company, but also in improper conduct or acting in bad faith beyond boundaries of normal commercial risks, with personal interests or abuse of discretion, in rendering clearly negligent or wasteful decisions.[221]

Although the formulation of this reasoning is quite complex, several strategic positions of the Court can be articulated. Firstly, the court recognized the trust origins of relationship between the director and a company – which resembles the exact origins of fiduciary duties. Secondly, the Court provided outline of different types of conducts that may constitute a breach

[220] The decision of the Supreme Court dated 04 December 2018 in case No. 910/21493/17; http://reyestr.court.gov.ua/Review/78412710 accessed 27 January 2019.
[221] *Id*.

of fiduciary duties – such as acting in bad faith or with personal interest. Overall, these points in reasoning are quite similar to the courts' interpretations of fiduciary duties in Delaware.

As for the merits of the case, the Supreme Court, relying upon the provisions of the Commercial Procedure Code, noted that the burden of proof in cases alike is on the plaintiff. As a result, the case was dismissed because the plaintiff did not present ample evidence as to the general director's *bad intentions* to enter into contested additional agreement. Interestingly, this Court completely disregarded the provisions of the Civil Code analogous to those contained in Art. 40 of the New Law – that the burden of proof is imposed on the director. Consequently, by resorting to the procedural law instead of the substantive law, the Supreme Court introduced the existence of some kind of the business judgment presumption.

To summarize the court practice, the abovementioned examples illustrate the reluctance of the Ukrainian courts to analyze the merits of the business decisions made by the directors on behalf of the company. Furthermore, the courts are utilizing this "business judgment presumption" even if the director provides some scarce proof as to the necessity to make the decision concerned. It is undisputable that the Ukrainian courts up to the Supreme Court are willing to employ the business judgment presumption in corporate governance disputes, while the New Law do not recognize this possibility.

Another phenomenon that arose due to the fact that directors' hands are tied (concerning their protection) is the active usage of labor laws in corporate governance disputes. In particular, directors may use the category of "normal productional and commercial risk" (in Ukrainian - *нормальний виробничо-господарський ризик*) to claim that their decisions, even if not successful, were made under the normal commercial risk and the court is not in the position to question them. The notion of "normal productional and commercial risk" stems from Article 130 of the Ukrainian Labor Code, which prescribes the general principles of monetary liability of employees toward their employers for the damages caused in the course of employment.[222] Although the scope of "normal productional and commercial risk" is not statutorily defined, the commentators argue that five conditions are necessary for establishing that the damage is caused due to the normal productional and commercial risk, namely: "the purpose of this risk could not have been achieved by other, not risky behavior; the risk corresponds to the meaning of the goal to which it is directed; the possibility of harmful consequences was unlikely; the object of risk is material values, not life and health of people; only persons with a certain professional training and experience are entitled to take such risk".[223]

The general jurisprudence of applying the concept of the normal productional and commercial risk clearly points to the low level of applicability of this mechanism and the lack of a unified vision on the part of practitioners. Obviously, in corporate governance sector this category has not proven to be helpful yet. For example, in the Decision of the Gadyatsky district court of Poltava region dated 12 October 2010 the court had to analyze the director's decision to dismiss the personnel of an LLC.[224] The director advanced an argument that such business decision was motivated by the best intentions and, thus, protected by the normal productional and commercial risk. The court dismissed this argument and held that the notion of the normal productional and commercial risk is applicable only in companies that are directly involved in the manufacturing activities.[225] Yet another court decision, the Decision of the District Administrative Court of Kyiv dated 1 September 2014, took different angle.[226] In this case the

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[222] Kodeks Zakoniv Pro Pratsiu Ukrainy [KZPP UA] [Labor Code] art. 130 (Ukr.).
[223] Chaltsev D.V., *Do Pytannia Kharakterystyky Normalnoho Vyrobnycho-Hospodarskoho Ryzyku* [To the question of characterization of the normal productional and commercial risk], 8 YURYDYCHNI NAUKY PROBLEMY TA PERSPEKTYVY 86, 87 (2014).
[224] The decision of the Gadyatsky district court of Poltava region dated 12 October 2010 in case No. 2-1042; http://www.reyestr.court.gov.ua/Review/11631440 accessed 16 January 2019.
[225] *Id*.
[226] The decision of the District Administrative Court of Kyiv dated 1 September 2014 in case No. 826/10831/14; http://www.reyestr.court.gov.ua/Review/40384887 accessed 16 January 2019.

director violated some tax laws and regulations that caused the company-JSC damages in form of fines paid to the tax authorities. The court noted that even if the director was negligent while making some business decisions, the damages cannot be attributed solely to his conduct since there is always some extent of the normal productional and commercial risk. As a result, the court did not question the substance of the director's decisions.[227] However, one reservation shall be made in this respect – this decision should not form an assumption that the normal productional and commercial risk is applied in corporate governance disputes, since by its very nature the District Administrative Court could not render decisions in the terrain of corporate law. Corporate law issues and, notably, corporate governance disputes fall within the exclusive jurisdiction of the commercial courts in Ukraine.[228]

Thus, the practical application the concept of normal productional and commercial risk in Ukrainian corporate governance disputes is rare, and existing cases are quite controversial. However, it should be emphasized that this concept in its substance is the product of labor law since it is prescribed and governed by the Labor Code. Therefore, no provisions of the Ukrainian corporate law offer the LLC directors' the protection similar to the business judgment rule.

3.2.2. Possibility to limit fiduciary duties by agreements

The possibility to limit directors' fiduciary duties is not explicitly recognized by Ukrainian legislation. Furthermore, it is not even mentioned in any of the statutes nor is it discussed in scholarly materials until now. Another issue that complicates an analysis on the limitations of fiduciary duties is an absence of the relevant court practice. Thus, this subchapter examines a theoretical possibility to limit directors' fiduciary duties in Ukraine by various agreements.

[227] *Id*.
[228] *See* Hospodarskyi Protsesualnyi Kodeks Ukrainy [HPK UA] art.20 (Ukr.).

Similarly to the Delaware's application, the charter of an LLC may be the proper source of limitations of fiduciary duties. Pursuant to Art. 11 of the New Law, a charter of an LLC is its constituent document.[229] The charter must contain only 3 main sets of provisions: (1) full and abbreviated (if any) name of the LLC; (2) information on the management bodies of the LLC, their competence, and the decision-making procedure; and (3) the procedure for entry into and exit from the LLC.[230] As a general rule, the charter may contain any additional information which does not contradict mandatory provisions of Ukrainian laws. Thus, the primary question is whether the provisions on directors' fiduciary duties can be construed as mandatory or as default ones. If they are default, the charter may legally provide for the limitation of fiduciary duties.

Although Art. 40 of the New Law (contains provisions on directors' fiduciary duties) does not prescribe the status of its provisions, it does not allow derogations from them as well.[231] Given that the formulation of such provisions is in an orderly way (in Ukrainian – *наказовий спосіб*) and this article uses such words as "must", "shall" and "cannot", it is unlikely that any commentator will consider it as being just a default article. Consequently, Art. 40 of the New Law, which contains the scope of director's fiduciary duties, shall be regarded as being of mandatory nature and the charter of an LLC may not alter it.

The situation is somewhat different from the perspective of the duty of loyalty. As was described earlier, this duty is described in the New Law quite extensively. Therefore, the nature of certain elements of the duty of loyalty may vary.

[229] The Law of Ukraine, 'On Limited and Additional Liability Companies' [6 February 2018], No. 2275-VIII, Art. 11 <http://zakon.rada.gov.ua/laws/show/2275-19> accessed 20 January 2019.
[230] *Id*.
[231] *Id*. Art.40.

To start with, the non-compete obligations are contained in Art.40(5) and, hence, are of mandatory nature. Additionally, the regulations on the conflict of interest are of twofold nature – while most provisions of Art.42 of the New Law are articulated as mandatory, the duty of confidentiality may be amended by the LLC and its director.[232] The rationale for a special treatment of the duty of confidentiality is the recognition of an exception to the general rule on the duration of fiduciary duties – the duty of confidentiality will not cease to exist upon termination of the employment in order to prevent the opportunistic behavior of the director that can be described as "exploitation of maturing business opportunities".[233] However, such limitations on the duty of confidentiality may concern only the duration of it after the termination of the agreement between the director and the LLC and they must be encompassed in such agreement, not in the LLC's charter. Finally, the prohibition of self-dealing has a distinct nature from the abovementioned elements of the duty of loyalty – it has only a default status. This entails that Art.45 of the New Law clearly states that the prohibition of self-dealing can be employed by an LLC on a voluntary basis and if the LLC's charter is silent on this matter, such default provisions of the New Law are not applicable at all.[234] Therefore, only one component of the duty of loyalty – the prohibition of self-dealing can be altered in the charter of the LLC.

Interestingly, the shareholders may also choose to adopt a short model charter of an LLC, which is approved by Cabinet of Ministers of Ukraine.[235] Although not mandatory in its nature, it, nevertheless, demonstrates the perception of an LLC's charter in the view of Ukrainian government. Concerning directors' fiduciary duties, it does not contain any provisions,

[232] *Id*. Art.42.
[233] STAFFORD & RICHIE, *supra* note 28, at 227.
[234] *Id*. Art.45.
[235] Degree of the Cabinet of Ministers of Ukraine, 'Pro Zatverdzhennia Modelnoho Statutu Tovarystva Z Obmezhenoiu Vidpovidalnistiu' [On the approval of the model charter of a limited liability company] [16 February 2011], No. 1182 https://zakon.rada.gov.ua/laws/show/1182-2011-%D0%BF accessed 20 January 2019.

meaning that its drafters decided not to provide any special regulations neither on fiduciary duties, nor on their limitations.

In summary, Ukrainian legislation permits a partial possibility to limit or modify the director's fiduciary duties – only regulation on interested party transactions, as a part of the duty of loyalty, is subject to modification in the charter of the LLC.

Another variant for limitation of fiduciary duties may be the shareholders' agreement. Article 7 of the New Law plainly permits the shareholders of the LLC to conclude the shareholders' agreement.[236] This is another novelty of the New Law which is aimed at the attraction of new investors. However, based on Art. 7(1) of the New Law, the scope of such agreement is limited to the realization of rights and discharge of obligations of the shareholders.[237] For example, the shareholders are able to establish the obligations to vote in a manner determined by such an agreement at a general meeting of participants of the LLC. They may also include into the agreements transfer instruments common in other jurisdictions such as tag along rights, drag along rights, call options and put options. Since the duties of directors fall with an ambit of corporate governance and are regulated by the mandatory provisions of Ukrainian statutes, it is unlikely that any court will enforce the limitations of fiduciary duties enshrined in the shareholders' agreements. The underlying reason for that is quite straightforward: as a general rule, the shareholders' agreement is confidential, so third parties do not have an option to verify the director's duties. In contrast, the charter of the LLC must be registered with the state and is publicly available upon payment of administrative fee.

Finally, the bylaws of the LLC may contain some provisions on duties and liabilities of the director. Usually such bylaws are in form of director's job instruction (in Ukrainian –

[236] The Law of Ukraine, 'On Limited and Additional Liability Companies' [6 February 2018], No. 2275-VIII, Art.7 <http://zakon.rada.gov.ua/laws/show/2275-19> accessed 20 January 2019.
[237] *Id*.

посадова інструкція директора) and stipulate not only the standards of conduct of the director, but also the rules on imposition of liability. Based on the examination of some publicly available examples[238], it is clear that such bylaws are of labor law nature and refer to the material (monetary) liability of the director for the breach of its obligations. This is another example of combined nature of corporate governance in Ukrainian companies – directors are exposed both to corporate and labor law regulations.[239] Although there is a theoretical possibility that the bylaws may limit the liability of the director for the violation of his fiduciary duties, it is doubtful that this will be upheld by the court. The main reason is that the director's job instruction is drafted on the basis of labor law, while fiduciary duties are product of corporate law – the court may state that the bylaw exceeds its legitimate purpose and scope.

In conclusion, current Ukrainian legislation allows only a scarce limitation of director's fiduciary duties. Since the New Law is in force for less than a year now, it is unclear whether and to what extent fiduciary duties of directors are modified in practice.

Chapter 3 Conclusions

This chapter discussed various legitimate ways to limit directors' fiduciary duties. Delaware law offers the business judgment rule as a powerful protection for directors, while Ukrainian legislation is silent on this matter. Even more, Ukrainian corporate law places the burden of proof in corporate governance disputes on the director, which is rather a negative phenomenon. One of the disadvantages of such lacunae in Ukrainian law is the emergence of attempts to use some concepts of labor law to shield the director's decision-making from the court's interference. Importantly, the analysis of an existing case practice in Ukraine

[238] *See, e.g.*, The job instruction of the director of an enterprise, Jobs.ua, https://jobs.ua/job_description/view/7 last visited 08 February 2019.
[239] *See* The decision of the Ukrainian Constitutional Court "upon the constitutional petition of the Limited Liability Company 'International Financial and Legal Consulting' on the official interpretation of section three of Article 99 of the Civil Code of Ukraine " dated 12.01.2010 No. 1-рп /2010, 3 Official bulletin of Ukraine No. 3, 113 (January 29, 2010) (on the clash between corporate and labor law in corporate governance in Ukraine).

demonstrates the willingness of courts to use the mechanism of the business judgment presumption. As for the limitation of fiduciary duties by agreements, Delaware law contains two methods – the elimination of personal monetary liability and waiver of fiduciary duties – depending on the form of the company. In Ukraine, on the contrary, limitations of directors' fiduciary duties by agreements are not recognized by the law yet. Given an outstanding difference between law of Delaware and Ukraine on this issue, the next chapter provides an outline of the possible implications of Delaware's approach in Ukraine.

Chapter 4. Implementation of Delaware's approach in Ukraine

The research conducted in connection with the preparation of this thesis has revealed some interesting issues on directors' fiduciary duties in Ukraine. This chapter provides recommendations as how to address these issues. It starts the basic idea whether Delaware's approach should be useful in Ukrainian practice and then discusses some general conceptual improvements that can be employed by Ukrainian policy makers. As the Ukraine strives to forge a new role on the world stage among global trading nation, the strength of businesses is critical to future success. The reform of corporate governance, which should cover the proposals outlined in this chapter, is conductive both for the incentivization of investments into Ukrainian LLCs and for providing powerful and transparent rules for managing the company's affairs.

The transplantation of foreign law into domestic legislation is a well-known phenomenon, one of the examples being the global reception of US securities regulation.[240] Even more, the term and concept of "corporate governance" itself in many countries is not even translated into the national language.[241] However, in transplanting different legal solutions from a developed county to a developing one such factors as social and economic development, corporate structures and enforcement mechanisms play a crucial role.[242] Indeed, different legal systems are using different ways to better serve a nation's goals of corporate law.[243] Since the general tendency is that countries with civil law setting embrace some common law trust

[240] FLECKNER & HOPT, *supra* note 7, at 26.
[241] *Id.*
[242] Kenneth W. Dam, *Equity Markets, the Corporation, and Economic Development* 20-21 (John M. Olin Program in Law and Economics, Working Paper No. 280, 2006), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=885196.
[243] Jun Zhao, *Comparative Study Of U.S. And German Corporate Governance: Suggestions On The Relationship Between Independent Directors And The Supervisory Board Of Listed Companies In China*, 18:3 MICHIGAN STATE JOURNAL OF INTERNATIONAL LAW 495, 509 (2010).

devices, there is much of value that these countries can find in Anglo-American fiduciary law.[244]

As this thesis demonstrated, Delaware successfully utilizes fiduciary duties of directors to enhance the quality and credibility of business decisions taken on behalf of LLCs and corporations. In contrast, directors' fiduciary duties in Ukraine remain to be an underdeveloped category not supported by legislator, while the judiciary is willing to embrace it. As rightly pointed out by Mariana Pargendler, there is a visible tendency toward the implementation of various governance features prevailing in Anglo-Saxon markets, such as fiduciary duties, to emerging market economies.[245] In this respect, focusing only on the adoption of identical corporate governance practices may occur to be even counterproductive, and, thus, functional, rather than formal, convergence should prevail.[246] Therefore, mere replacement of rules existent in Ukraine nowadays with Delaware law in its exact form is not a viable option due to the different approaches to corporate law regulations.

As characterized by York Schnorbus, Delaware as "the most important corporate law jurisdiction in the United States, is so flexible, resourceful, and rich in ideas, that it might be both difficult and challenging for European continental lawyers to explore or create similar rules and to institute them in their civil legal systems."[247] Indeed, Kenneth W. Dam, citing Richard Posner and referring to the Japan's example of borrowing the duty of loyalty, argues that the standards of fiduciary duties, which are keys to corporate governance litigation in the United States, make little sense for a developing country.[248] Although such these suggestions

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[244] Thomas P. Gallanis, *The contribution of fiduciary law*, in THE WORLDS OF THE TRUST 388, 405 (Lionel Smith ed., 2013).
[245] GORDON & RINGE, *supra* note 22, at 749.
[246] *Id*. at 750.
[247] York Schnorbus, *Tracking Stock in Germany: Is German Corporate Law Flexible Enough to Adopt American Financial Innovations*, 22 U. PA. J. INT'L ECON. L. 541, 544 (2001).
[248] Kenneth W. Dam, *Equity Markets, the Corporation, and Economic Development* 16 (John M. Olin Program in Law and Economics, Working Paper No. 280, 2006), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=885196.

may seem quite reasonable given that "standards [of fiduciary duties] are likely to be difficult for developing country judiciaries to apply effectively"[249], the author of this thesis still believes that several aspects of Delaware's practice can be introduced in Ukraine. The ensuing proposals are devoted to the analysis of ways of improving Ukrainian laws in the area of directors' fiduciary duties taking into account the lessons from Delaware's perspective.

Conceptually speaking, it seems reasonable that the New Law should provide a detailed guidance on the directors' fiduciary duties. The underlying reason is that the civil law traditions differ dramatically from the common law ones, and, thus, it is crucial for Ukrainian practitioners to have solid legal basis of fiduciary duties stipulated in the statute. The proposed "Model Company Law for Transition Economies", which is based on the Yugoslav Enterprise Law and the recommendations provided by Peter Beherens, follows the same approach as to distinguish between Anglo-Saxon and civil law description of fiduciary duties.[250]

Firstly, in Delaware directors have a well-established obligation to inform themselves of all material information reasonably available to them before making a business decision and to act with the necessary care in making such decision.[251] On the contrary, in Ukraine the duty of care is not defined and, therefore, courts struggle to implement the concept of care in corporate governance disputes. Therefore, it is advisable to define the concept of the duty of care in the New Law – for example, as an obligation to make business decision on informed basis. Such definition should contain the list of relevant elements for determining the compliance with the duty of care. Based on the Delaware practice, such elements may include at least the scope of application (prior to making a business decision and also in the oversight context) and the reliance standard (when directors are relying upon information provided by insiders or outsiders). Furthermore, the consequences of the shareholders' ratification of the conduct in

[249] *Id*. at 17.
[250] JANET DINE ED., COMPANY LAW IN THE NEW EUROPE: THE EU ACQUIS, COMPARATIVE METHODOLOGY AND MODEL LAW 179 (2007).
[251] Van Gorkom, *supra* note 71, at 872.

breach of the duty of care should also be outlined in the legislation, because if such ratification can extinguish the duty of care claims directors are given valuable protection and incentive to act in the transparent manner. The role of shareholders' ratification can be summarized as "informal business rescue" for the director's mistakes.[252] Moreover, it is recommended to form special rules concerning the waste claims, *e.g.* when the director entered into clearly egregious transaction detrimental to the LLC, for the reason that such suits form the basis of Ukrainian corporate governance disputes in the meantime. Such special rules should elaborate the standard of care required from the director before entering into particular transaction, as well as specify an effect of the subsequent shareholders' ratification (although in Delaware the ratification of the director's conduct in waste claims cannot serve as a "safe harbor", Ukrainian policymakers may adopt a different view).

Secondly, at the legislative level in Ukraine the director's duty of loyalty is regulated quite extensively. The New Law contains rules on non-compete obligations, conflicts of interests and the prohibition of self-dealing. From the point of consistency, it is advisable to introduce the general definition of the duty of loyalty – for example, that it is the obligation of the director to abstain from utilizing his managerial position to further private interests. To provide general outline of the duty of loyalty, the legislator should envisage some examples of the director's conduct in breach of the duty of loyalty. Based on the Delaware's experience, such examples may be (1) engaging in an interested transaction; (2) obtaining profit from the use of confidential corporate information; (3) taking any action solely or primarily to entrench or perpetuate himself in office; (4) otherwise placing benefits to himself or to affiliated entities ahead of benefits of the corporation. Only after the description of this general concept of the duty of loyalty, the specific articles on its elements should be carefully drafted. This stage

[252] Marjan Marandi Parkinson, *Conclusions, in* CORPORATE GOVERNANCE IN TRANSITION: DEALING WITH FINANCIAL DISTRESS AND INSOLVENCY IN UK COMPANIES 286 (2018).

should involve, in particular, the consolidation of all the provisions related to the duty of loyalty in one subchapter or in few consecutive articles of the New Law. Furthermore, one specific article should be devoted to the duty of disclosure which is a crucial element as to balancing the duty of loyalty – the shareholders and directors should understand the importance and consequences of disclosing all problematic matters and the advantages of acting in a transparent manner. The proposed reform on the description of the duty of loyalty will lead to sustaining well-organized and transparent description of the duty of loyalty comprehensible to the general public instead of having scattered and conflicting provisions that can be perceived and interpreted only by lawyers.

Thirdly, the meaning and scope of the duty of good faith remains unclear both in Delaware and Ukraine. Hence, two approaches may be used by the legislator as regards its interpretation. On the one hand, the New Law may continue to oblige the director to the fiduciary duty of good faith. However, in such case the meaning of the duty must be clarified so that the courts have a solid legal ground to invoke the duty of good faith in disputes. The meaning of the duty of good faith proposed by the Delaware Chancery Court in *Disney* case may be used for such clarification as it collides not only with the opinions of Ukrainian scholars, but also with the interpretation by the Ukrainian courts.[253]

On the other hand, the legislator may decide to remove the duty of good faith at all given that it is, arguably, almost unenforceable fiduciary duty of directors. Such approach would not get rid of the existence of the good faith in corporate governance, since, as Myron T. Steele rightly stresses, it is better to apply the implied contractual covenant of good faith and fair dealing instead of rhetorical and undefined duty of good faith.[254] Unless Ukrainian corporate governance jurisprudence changes its way of development, the fiduciary duty of good faith will

[253] The intent of the Moscow district court of Kharkiv city in its decision dated 08 October 2016 clearly resembles "subjective bad faith" standard proposed by the Delaware Chancery Court.
[254] Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 31 (2007).

remain to be almost meaningless and opaque. This, perhaps, justifies its removal from the scope of directors' fiduciary duties in the process of clarification of Ukrainian corporate law.

A big step towards enhancement of corporate governance in Ukraine would be an introduction of the concept of the business judgment rule. Since Ukrainian courts demonstrate the desire to shield the director's decision-making procedure from unnecessary courts' interference, this novelty will represent the already shaping practice. In this respect the legislator, firstly, has to clarify the meaning of the category of "normal productional and commercial risk" by tying it only to the application of labor law. Secondly, the provision in the New Law that places the burden of proof in corporate governance disputes on the director shall be changed diametrically – to place it on the plaintiff. As drafting history of the New Law demonstrated, there was a political will to do so once. Thirdly, the business judgment rule as such shall be prescribed in the New Law. In order to do so, the legislator may begin with its definition and description of criteria of its application.[255] Borrowing from the Delaware's experience, such criteria may be (1) the presence of a business decision; (2) independency, due care and good faith on the part of the director; and (3) prohibition of discretionary abuse. Following this, the juridical nature of the business judgment rule shall be clarified in the New Law. As comparison of two competing theories in Delaware illustrates, the treatment of the business judgment rule as an abstention doctrine is more advantageous to the management of the company. Moreover, the practice of Ukrainian courts also proves that they already employ something akin to "the business judgment rule" as a negative presumption on judicial review of directors' decisions.

As for limitations of fiduciary duties by agreements, there are essentially two main approaches in this respect in Delaware – the broad limitations for LLCs and the limited for

[255] The statutory definition of the business judgment rule prescribed in Section 180(2) of the Australian Corporations Act may be used as an example. *See, e.g.*, FLECKNER & HOPT, *supra* note 7, at 126.

corporations. On the contrary, Ukrainian corporate law does not recognize any limitation of directors' fiduciary duties. In fact, the Ukrainian LLC in its nature is closer to the closed corporation in Delaware subject to numerous mandatory regulations rather that to Delaware's LLCs with an extensive freedom of contract. Therefore, it is advisable to follow the pattern of limitations of fiduciary duties prescribed by the DGCL - through the limitation of director's liability. Furthermore, the credibility of such approach is sustained by the fact that the New Law already contains the mechanism similar to the concept of renouncing corporate opportunities used for corporations in Delaware - the possibility to forbid self-dealing transactions for LLCs directors. The appropriate agreement for establishing fiduciary duties' limitations is the charter of an LLC, as described earlier.[256]

It is undisputed that different political forces, diverging economic interests, and lobbying activities influence the overall policy-making decisions and, notably, may determine which spheres of life are being prioritized by the legislature.[257] In this respect, reformation of directors' fiduciary duties in Ukraine may lead to the enhancement of market integration, competitiveness and, surprisingly, sustainable development. The link to the sustainable development can be traced through an example of investments into vulnerable sectors, such as mining industry in Ukraine, which require the directors to take "environmental and social issues into account for their own sake, regardless of whether doing so is expected to improve financial performance".[258] The changes proposed above will make Ukrainian corporate law more uniform and consistent. Provided that Ukraine follows the lessons from Delaware's approach as regards directors' fiduciary duties, it is likely that the quality of corporate

[256] *See supra* Chapter 3 (3.2.2).
[257] SJAFJELL, *supra* note 156, at 251.
[258] Christine Berry, *Fiduciary Duty and Responsible Investment: An Overview, in* RESPONSIBLE INVESTMENT BANKING: RISK MANAGEMENT FRAMEWORKS, SUSTAINABLE FINANCIAL INNOVATION AND SOFTLAW STANDARDS 532 (Karen Wendt ed., 2015), https://doi.org/10.1007/978-3-319-10311-2_35.

governance within Ukrainian LLCs will increase dramatically, and more foreign investors will become interested in penetrating Ukrainian market.

Chapter 4 Conclusion

This chapter looked at the problems of a specific aspect of corporate governance - directors' fiduciary duties. It proposed an avenue of substantial amendments to corporate and labor law of Ukraine. As for the labor law, the legislator has to clarify the meaning of the category of "normal productional and commercial risk" so as to avoid its wrongful application in corporate governance disputes. The most important novelties to be introduced into corporate law include careful drafting of certain directors' fiduciary duties in the New Law, recognition of the business judgment rule and the limitations of fiduciary duties by the charter of an LLC. These amendments will help Ukraine to obtain reputation for being a dependable and confident place for conducting a business, because both investors and managers of companies will be able to use consistent and transparent legal rules for balancing the accountability and discretion in managing LLCs.

Conclusion

The concept of fiduciary duties is rather fluid, elusive and atomistic. Fiduciary duties may arise in myriad relationships where one person (agent) undertakes to act on behalf of another (principal) and to exercise the discretion affecting the welfare of the principal. In corporate law context, fiduciary duties play a crucial role due to the divergence of interests between the shareholders as owners of a company and its directors who hold powers of control.

Although Delaware and Ukrainian corporate law belong to different legal systems, each of them imposes on a director certain extent of fiduciary duties. Whereas the duty of care is not recognized in Ukraine, the duty of loyalty seems to have the same conceptual underpinning of subordinating director's personal interests to the interests of a company in both jurisdictions. The existence of the duty of good faith is questionable in Delaware and Ukraine. However, the standards of fiduciary duties are different in scope as well as the standards on the imposition of liability.

The courts in Delaware defer to the director's decision-making under the business judgment rule provided that certain preconditions are met. On the other hand, the business judgment rule does not exist in Ukraine the directors of LLCs bear the burden of proof in case of corporate governance dispute. As regards limitations of directors' fiduciary duties, Delaware law provides for various mechanisms that can be prescribed by agreements depending on the type of company. Contrary to that, Ukrainian legislation does not allow limitations of fiduciary duties, except for the possibility to modify default rules of directors' self-dealing transactions.

This thesis proposed some ways of improvement in Ukrainian law and, in particular, in the field of corporate governance and labor law. One should not forget, however, that it is impossible at this moment to predict the short-term result of reform in the field of directors' fiduciary duties in Ukraine. When Japan decided to borrow the Illinois concept of directors' duty of loyalty, the result has been noticed only after decades of observation. As noted by

Hideki Kanda and Curtis J. Milhaupt, “Japan's experience with the duty of loyalty shows that even a poorly motivated and ill-fitting legal transplant may become a core rule in the host country over time, as the legal infrastructure and political economy change.”[259] Thus, the research and recommendations in the field of directors’ fiduciary duties in Ukraine will always remain topical.

[259] Hideki Kanda and Curtis J. Milhaupt, *Re-Examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law*, 51 THE AMERICAN JOURNAL OF COMPARATIVE LAW 887, 900 (2003).

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