

## **CORPORATE GOVERNANCE AND THE INTERNAL STRUCTURE OF COMPANIES - QUESTIONS OF LIABILITY**

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### **I. Corporate Governance and liability**

Company laws have long been searching for the perfect system of safeguards in order to ensure the credibility and solvency of companies, and to protect the best interests of the creditors. This understandable attempt invoked shifts of paradigms multiple times over the past few decades. As the economic environment and market rules have a huge impact on the evolution of company laws worldwide, the new challenges of the 21<sup>st</sup> century – especially the aftermath of the most recent financial crisis – raise new questions in the area of company law. Companies are the creations of national laws as international business law and even the supranational law of the European Union have not been able to establish a framework system for companies.<sup>1</sup> This phenomenon results in very diverse concepts for company laws even in countries that being geographically close to each other. Not only universal unification or harmonization but regional approximation of laws suffers from firm motivation of the states as they all believe that company laws must reflect national specialties as parts of the culturally diverse field of private law. Another obvious opposition of the states these days is the fact the company law may boost economy and the willingness of foreign investors to start businesses in the given country. In case of a desired approximation, even in a regional level, the competitiveness of some countries may also be in danger, and investors would not consider company law as a relevant factor when making their decision on where to position the company. The other angle of such diversity is that national laws aim to provide safeguards to the creditors in different ways. These safeguards may be categorized based on what aspect of company law they select as the ground for ensuring warranties. It can be the core capital, the internal structure and the relationship between the various company bodies, or the liability of the key figures acting on behalf of the company. None of these ideas were proved to be perfect offering a solution to all possible claims of the creditors, however, weaknesses and strengths may be identified in the various concepts, and the position the state takes on this important questions most likely describe the general approach to company law in the given country. We tend to believe that every decision in the area of company law has impact on the decisions of the investors, therefore, it results changes in the attitude of the investors that impact the economy and the market in that state. However, if we really want to be honest, the nature and content of company law is just one of the many factors investors consider when making a decision on where and how to run their businesses. Tax laws, procedural rules, access to justice and alternative dispute resolution methods are equally important, and the obvious factor of consumers' buying power, wealth, political stability and other natural attributes of the market all play significant roles in this respect.

For decades, company laws followed a somewhat simple approach to provide safeguards to creditors against the insolvency and fraud of companies. This approach believed that in case a business association type (typically partnerships) involves background liability of the members for the debts of the business association, the core capital has no function in providing safeguards to creditors, therefore, minimum requirements for the core capital were either non-existent or served only one purpose: to get the members engaged in the business activity and make them invest something at the formation stage. In case the law established for a business association type allowed members/shareholders to limit their liability for the debts of the company, the law commonly imposed a minimum core capital obligation to the founders in exchange for their limited liability. This theory worked – and in some places it still holds – as a form of pre-check

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<sup>1</sup> Court of Justice of the European Union (CJEU), *The Queen v H. M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc*. Case 81/87 par. 20

at the stage of establishing a company, and allowed company registration courts or authorities to decide whether the company complies with the legal requirements and can get allowed to step on to the market and start conducting business activity. Soon, however, this core capital centered concept proved to be somewhat inefficient during the operation of companies as the core capital requirements at the formation stage could not ensure that those acting on behalf of the company take all necessary and reasonable steps to prevent the insolvency of the company as their liability was not an issue since they ‘purchased’ their immunity when they complied with the minimum core capital requirements. The end of the 20<sup>th</sup> century and then the financial crisis in 2008 urged legislators and courts to evolve new concepts in order to guarantee the protection of the creditors and to ensure the transparent operation of the business associations. Wrongful trading rules, however, were established for the managers and those considered to be the key personnel of companies at the early stage of the shift of concepts. Still, legislators and courts had to face the fact that the decision-making bodies of the companies that consist of the shareholders/partners may play an equally important role in pushing the company to insolvency through bad, malicious or unreasonably risky decisions. The various models on the relationship between the decision-making body and the management of a company also raised concerns that shareholders/members may also be liable for the debts of the company toward the creditors in certain situations. The liability of shareholders is obviously more eminent in private companies, close corporations than in public ones as shareholders have a more obvious control over the company’s operations. Also, in the special situation of company groups (e.g. holdings) and dominant, majority shareholders, the liability of shareholders get to another dimension. This study analyzes the theoretical considerations behind the concept on shareholders’ liability in general, and describes selected models and cases in Europe and in the United States in order to identify the new trends and cases when the liability of shareholders toward the company or its creditors and third parties may be relevant.

## **II. The internal structure of companies and the interaction between the organs**

Most company structure models accept that one body of the company, the supreme body cannot be seized from its general function: to serve as a decision-making body. It also results that the various models leave the decision-making power of the supreme body intact and their primary focus is on how to ensure that the management is properly supervised for the best interest of the company and the shareholders. The supreme body, however, has a right to transfer some of its powers to either the management or the supervisory board. Most jurisdictions leave only a few fundamental decisions in the hand of the supreme body: to decide on the financial report of the company and to decide on what to do with the profit. This is why in many public companies, the general meeting of the shareholders is only called once a year and only to discuss these two strategic decisions. The rest of their competences are delegated to the management. In the German structure model, the supervisory board gets decision-making powers over the management of the company in order to promptly sanction any irregular or potentially harmful act of the management.<sup>2</sup> In this case, the shareholders do not have to evaluate the concerns of the supervisory board, they only have to pick the right and trustworthy members to the supervisory board. The classic structure concept on the clear separation of duties believe that decision-making must remain in the hands of the shareholders. It grants the final decision to the supreme body, and the supervisory board only monitors the activity of the management and report the irregular or potentially harmful acts to the supreme body that will eventually rule on the question.<sup>3</sup> Finally, the third structure model merges the functions of management and

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<sup>2</sup> HOPT, Klaus J., *The German Law of and Experience with the Supervisory Board*, Law Working Paper no. 305/2016. p. 3.

<sup>3</sup> HOPT, *i.m.*, p. 2.

supervision into one special body, the board of directors that involves executive and non-executive directors as well, providing typically majority voting rights to the non-executives in questions of the management.<sup>4</sup> We should see that the shareholders take very different positions depending on which structure model the company follows. In case of the strong supervisory board and the board of directors concepts, the shareholders have limited options to get close to the operation of the company, therefore, their potential to cause damage to third parties or to the company itself is minimal. In case of clear separation of powers model, the shareholders can and do keep a close eye on the operation of the company, and they may be involved in the process that ultimately pushes the company to the edge of insolvency. Even in this model, the question of liability may become very complicated. Corporate torts also presume some fault on the side of the tortfeasors, in our case, the shareholders. Fault, however, is a very fragmented category as the method on how to measure someone's negligence or intention strongly depends on the following factors: the level of his knowledge, access to information, state of mind, professionalism etc. We cannot state that shareholders are professionals in every case and that they understand the way of business in the sector the company is acting in. Therefore, general rules are difficult to establish based on the simple fact whether the shareholder supported the wrong and harmful decision or not. Company laws typically suggest that shareholders are persons that also need protection against the management, and minority shareholders may enjoy extra rights against the decisions of the majority.<sup>5</sup> This approach suggests that shareholders take different positions when we examine their level of knowledge, their access to information, and their professionalism and competency related to business matters. This is why in a limited liability company, the starting point is that shareholders will not held liable for the debts of the company and for the unsatisfied claims of the creditors. Still, it is not difficult to feel the anomaly between the function of the supreme body and its members, the shareholders, and this somewhat lenient interpretation of fault. The supreme body of the company has authority over the acting organs and persons of the company by electing them, supervising them, authorizing them and showing guidance to them through some strategical decisions (e.g. amending the instrument of constitution, the articles, deciding on raising or reducing capital etc.). It means that these decisions of the supreme body also function as beacons to the management, and the acts of the management can only be judged through these instructions. If these instructions are proved to be wrong and harmful, managers may have a successful defense against a tort claim, and also the creditors can easily be left without satisfaction.<sup>6</sup> The structure of the company may seem to be a question of internal matters of the company, and still, it has a significant impact on whether the liability of shareholders may become an issue or not.

### **III. The concept of limited liability – win or lose for shareholders**

Limited liability became the essential characteristic for most companies, and it successfully resulted that shareholders may invest in multiple firms, creating a diverse stock portfolio, while it also led to the fact that more investors could participate in the market.<sup>7</sup> The doctrine of limited liability, however, eroded especially because corporate torts (e.g. environmental torts, accounting frauds) claimed for a concept that allowed creditors to pierce that thick corporate veil. We have to state that the concept of limited liability only protects the shareholders' assets

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<sup>4</sup> HOPT, *i.m.*, p. 3.

<sup>5</sup> See Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies.

<sup>6</sup> MENDELSON, Nina A., *A Control-Based Approach to Shareholder Liability for Corporate Torts*, Columbia Law Review, Vol. 102. p. 1231.

<sup>7</sup> KAHAN, Daniel R., *Shareholder Liability for Corporate Torts: A Historical Perspective*, The Georgetown Law Journal, Vol. 97. p. 1086.

and the assets of the company. Also, the doctrine of limited liability only counts if the tort or wrongdoing was committed by the company. In case the shareholder acts in a tortious capacity, outside the general scope of the limited liability doctrine, he may be held liable personally. The important question is to identify these cases when the shareholders did not act under scope of this principle, rather, they stepped out of the veil of the company and committed a tortious act. Limited liability should only protect shareholders against the claims of creditors and other third parties (e.g. injured parties of a tort claim) if the claim arose from an activity that can be recognized as the general risk of conducting business activities. A company becoming insolvent does not necessarily mean that it is a case when the shareholders must bear individual responsibility for the unsatisfied debts. We need an extra factor based on the circumstances that justify the claim against the shareholders. This link has to be obvious and certain. Cases in various jurisdictions analyzed situations when the shareholders used their limited liability to maliciously satisfy their personal needs not in relation to the business activity of the company using the company's assets<sup>8</sup>, cases when the shareholders kept the management in tight leash and practically forced their will to them that eventually led to insolvency<sup>9</sup>, and cases when the sole member of the company was found personally liable for the debts as the sole purpose of setting up a company was to create a scheme, a front to his malicious activity<sup>10</sup>. A shareholder was also found liable for the company's debts and the doctrine on the corporate veil was pierced by the court when the shareholder made an economically destructive withdrawal. Such liability, however, can only arise if the shareholder intentionally inflicted damage on the company by withdrawing assets which would have been necessary to settle the company's debts, and that led to the insolvency of the company.<sup>11</sup> All these cases have one thing in common: shareholders abused their limited liability, and this is why they were found liable.

The concept of limited liability of the shareholders go back to the original approach on companies that these entities are separate from their founders, therefore, they have their own assets and their own liability for the decisions private individuals make on their behalves. Case law attached to limited liability, however, changed a lot almost everywhere in the world. The famous case of the United Kingdom, *Salomon v A. Salomon & Co Ltd* set grounds for the theory on the company being a separate legal entity back in 1896.<sup>12</sup> The case analyzed whether the shareholder owning the vast majority of the shares in a company can be held liable for the act of the company. According to the facts, Salomon sold his own company the business of making boots and shoes he conducted as a private entrepreneur. Mr. Salomon and his family members were the shareholders of the company in question. The company – under a contract - purchased the business of the private entrepreneur and issued the shares to Salomon and his family members. Parallel to these events, the company issued a debenture to Mr. Salomon that was secured by a floating charge on the assets. The business soon became insolvent, and the creditors of the company sued Salomon instead of the insolvent company, claiming that Salomon and his company were basically one and the same. They claimed that his debenture was void as no one can be his own creditor. The court sustained the concept of limited liability and that the company was a legal entity separate from its founder and rejected the claim. Another case from the common law world, however, took a different position even if the claim related to a contractual obligation. In the *Gilford Motor Company Ltd v Horne* case, Mr. Horne – a former employee of Gilford Motor Company – quit in order to establish his own limited liability company.<sup>13</sup> Before quitting, Mr. Horn had to agree in the form of a contract that he

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<sup>8</sup> United States of America, *Kinney Shoe Corp. v Polan*, 939 F.2d 209 (4<sup>th</sup> Cir. 1991).

<sup>9</sup> United Kingdom, *Re Hydrodan (Corby) Ltd* (1994) 2 BCLC 180.

<sup>10</sup> United States of America, *Flash v Conn*, 109 U.S. 371.

<sup>11</sup> Germany, Federal Court of Justice 23 April 2012 (II ZR 252/10).

<sup>12</sup> United Kingdom, *Salomon v A Salomon & Co Ltd* (1896) UKHL 1, (1897) AC22.

<sup>13</sup> United Kingdom, *Gilford Motor Company Ltd v Horne* (1933) Ch 935.

would not solicit any of his former employer's, Gilford Motor Company's customers. Horne claimed that he took that obligation as a private individual and that his newly formed company is a separate legal entity that is individually liable for its own actions, and he as the shareholder of the company cannot represent the company and its will. The court ruled for Gilford Motor and observed that the company and Horne were one and the same, and Horne committed a fraudulent activity when he tried to go behind his contractual obligation by forming a company. It is really difficult to see a pattern here. Both cases were about contractual obligations, still, the court in the Salomon case enforced the concepts of limited liability and separate legal entity, while in the Gilford Motor Company case, the judge went behind the company veil concept and allowed the plaintiff to get protection against the fraudulent activity of the shareholder. If we take an in-depth analysis of the two cases, we can see a notable difference in the facts. In Salomon, it is really difficult to prove the intention of Salomon that forming a limited liability company served a fraudulent purpose. Since Salomon's family got involved in the business and that required Salomon to transfer his successful business to the family run company, the insolvency does not seem to be an intentional fraud of Salomon. In Gilford case, however, Horne clearly set up the company to escape from the contractual obligation he took, therefore, the exception under the limited liability rule seemed adequate. The Gilford argument was applicable in the *Kelner v Baxter* case as well. Baxter and two of his associates took an obligation on behalf of a company yet to be formed to buy trade stocks for their businesses.<sup>14</sup> Later, they formed the company, and accepted and used the trade stock but never paid for the stock. The court ruled that since the company was not even formed when Baxter and his associates took the obligation, they had to bear responsibility for paying the stock. The company could not be held liable as it could not ratify a pre-incorporation contract with retrospective effect to a date before the company existed. The *Kelner* case proved that courts can easily penetrate through the company's protective veil in cases when the shareholders acted with clear fraudulent intention. On the other hand, when the shareholder is the one that requires that his assets and the company's assets should be treated the one and the same, the courts are not willing to accept this argument. Another interesting case from the case law of the United Kingdom, the *Macaura v Northern Assurance Co Ltd* case proves this angle of the dispute.<sup>15</sup> Mr. Macaura was a landowner who sold timber from his estate to a company of which he was the sole owner. He insured the timber that was laying on his land under his own name as the insured person as shown by the policies issued by the insurance company. A few weeks later, the timber was destroyed in a fire. Macaura claimed the insurance money based on the insurance policy. The insurance company claimed that the timber belonged to the company and not to Macaura, and as a consequence of it, the destroyed timber was not properly insured, and the insurance company is not obliged to pay the insurance money. The court noted that the timber belonged to the company at the time of the fire, and Macaura is not identical to his private limited liability company, therefore, he had no insurable interest over the timber. This brief analysis of some historical cases in the laws of the United Kingdom proves that courts are willing to break the concept on the shareholders' limited liability in cases when a clear fraudulent activity or intent of the shareholders can be proved. The concept of limited liability, however, stands in all other cases when the creditors or claimants simply wish to use the shareholders' assets for satisfaction. We may conclude that the concept of limited liability of the shareholders separates the assets of the company from the assets of the shareholders, and the shareholders are not held liable for the contractual obligations of the company and for its debt under normal circumstances. Simply, until the shareholders play by the rules and respect the purpose of the limited liability principle, they are protected from the company's creditors and, in general, from third party claims.

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<sup>14</sup> United Kingdom, *Kelner v Baxter* (1866) LR 2 CP 174.

<sup>15</sup> United Kingdom, *Macaura v Northern Assurance Co Ltd* (1925) AC 619.

#### IV. Piercing the veil

The concept of limited liability was originally created to protect shareholders from the inevitable risks of business activities and against the claims of those that suffer harms and damage as a consequence of the risky business activities. The doctrine also wanted to encourage investors to invest in businesses risking only the money they invested and not their own assets. If the doctrine is used to hide a malicious activity behind the thick veil of the company, shareholders cannot enjoy the protection of limited liability. The concept of limited liability might have overcome the norm of unlimited liability by the 19<sup>th</sup> century, legislators in Europe and the United States started to come up with excuses under the rule in order to make shareholders accountable for certain unlawful behaviors. One of the still existing exceptions is the problem when the shareholder transfers property to the company at an over evaluation of its true market value. Some authors resemble this problem as the problem of ‘watered stocks’.<sup>16</sup> Watered stocks are harmful to the other shareholders and the company, and to the creditors too. The company makes a bad deal in such situations, while the creditors get a false picture on the solvency and the capital of the company. This concept leads us back to the importance of the minimum core capital. Since the core capital was the price for the limited liability and also an instrument to build trust toward the creditors, any fraudulent activity related to the core capital may undermine its importance and function. In Europe, most national laws insisted on having an accountant or other professional to evaluate the monetary value of any in-kind performance a shareholder wanted to contribute with to the core capital. This rule, however, disappeared from many legal systems as it, especially in case of private companies, formed an unnecessary burden and expense at the time of company formation. It led to a more lenient policy that allowed shareholders to evaluate the monetary value of the in-kind performance with mutual consent, and also created liability on their side in case an over evaluation was carried out with bad faith.<sup>17</sup>

Other historically relevant situations can also be identified in which the legislator felt the need for an exception to the limited liability principle. In the American continent, for example, some states (e.g. New York, Illinois, Canada) adopted the concept of shareholders’ joint and several liability for unpaid workers’ wages.<sup>18</sup> This view emerged from the fear that limited liability will serve as a tool for the rich to consolidate their wealth, to the detriment of the workers.<sup>19</sup> Also, certain exceptions were created to hold the shareholders liable for the full extent of their investment for company debts. It is an important principle when national laws levied the rules on when to pay the full amount of the shareholder’s contribution. In private companies, it is especially common that the legislator gives grounds for delayed payments, and the shareholder only has to provide a certain amount of his contributions at the time of formation; the rest may be paid at a later period of operation.<sup>20</sup> This rule got significant importance in the years of the

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<sup>16</sup> COOK, William W., “Watered Stock” – Commissions – “Blue Sky Laws” – Stock Without Par Value, Michigan Law Review, Vol. 19, p. 584.

<sup>17</sup> Hungary, Annex 1 II/1(bb) of the Company Registration Act 2006 that allows shareholders to evaluate the value of the in kind performance without having an auditor to perform this action.

<sup>18</sup> TUCKER, Eric, *Shareholder and Director Liability for Unpaid Workers’ Wages in Canada: From Condition of Granting Limited Liability to Exceptional Remedy*, Law & History Review, Vol. 26., p. 66.

<sup>19</sup> TUCKER, *i.m.*, p. 68.

<sup>20</sup> Hungary, Article 3:162(1) of the Civil Code 2013: “Where according to the memorandum of association a member is required to provide less than half of their respective cash contribution before the application for registration is submitted, or if the memorandum of association provides for a time limit of over one year from the time of registration of the company for making available the part of the cash contribution that was not paid before the application for registration is submitted, the company shall not be allowed to pay any dividend insofar as the unpaid profit calculated relative to the members core deposits according to the provisions on the payment of

most recent financial crisis. In order to support businesses and to make the company formation process easier, mostly legislators in the European continent levied the rules on shareholder contribution. If, however, the company's debts cannot be satisfied from the company's assets, creditors may turn against the shareholders who still have not performed their full contributions as undertaken in the instrument of constitution of the company, and force them to pay the rest. It is an interesting observation how this rule made some plaintiffs to try their cases in situations of corporate torts against the creditors. Courts, however, systematically deny that such rules could give grounds to individual liability of the shareholders for torts committed by the company.<sup>21</sup> It is clear that this rule was created only to help contractual creditors and not claims arisen from a tort.

It seems to be the norm that shareholders may only be individually or jointly and severally liable toward third parties if these third parties are contractual creditors, and their claim arises from the fact that the company's assets were insufficient to satisfy their claims. To summarize it, all fraudulent activities of the shareholders should somehow be connected to the intent to empty the company's assets.

## V. Dominant shareholders

In both public and private companies, shareholders act through majority decisions. A majority decision typically requires the consent of more than one shareholders, therefore, liability cannot be imposed on one of them simply by stating that they governed the company into insolvency. In a company, the owners are the shareholders, while the control over the daily operation is the duty of the management. Company managers or directors bear liability for the actions they take to represent the company toward the company itself. In most jurisdictions, they are rarely liable directly towards the creditors of the company or third parties who suffer harms or damage as a result of some tortious activity. Usually in tort cases, the directors are liable directly or jointly and severally with the company toward the third parties if they acted with intent.<sup>22</sup> In contractual obligations, the legislator lists those cases when the directors owe a direct liability toward the company's creditors.<sup>23</sup> In the latter cases, the so-called wrongful trading principles may serve as grounds for the director's liability toward the creditors of the company in case the company's assets are not enough to satisfy their claims. Shareholders on the other hand do not have individual and direct liability toward the creditors even in these cases as they only marked some strategical points for the daily operation through their decisions in the supreme body. This concept immediately changes when a shareholder gets the majority of the shares, or he *de facto* or *de jure* exercises control over the operation of the directors. Controlling shareholders dominate the company through their majority voting rights or through their control rights over the management/directors, and it leads to two special forms in the shareholders' liability.

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*dividends reaches the initial capital together with the cash contributions which the members have already paid up.*"

<sup>21</sup> Germany, BGH VersR 1972, 274 MDR 1972, 316.

<sup>22</sup> Hungary, Article 6:540(3) of the Civil Code 2013.

<sup>23</sup> Hungary, Article 33/A(1) of the Bankruptcy Act 1991: "*Any creditor or the liquidator - in the debtors name - may bring action during the liquidation proceedings for the court to establish that the former executives of the economic operator failed to properly represent the interests of creditors in the span of three years prior to the opening of liquidation proceedings in the wake of any situation carrying potential danger of insolvency, in consequence of which the economic operators assets have diminished, or that they prevented to provide full satisfaction for the creditors' claims, or failed to carry out the cleaning up of environmental damages. Any person with powers to influence the decision-making mechanisms of the economic operator shall also be considered an executive of the economic operator. If damage is caused by several persons together their liability shall be joint and several. A situation is considered to carry potential danger of insolvency as of the day when the executives of the economic operator were or should have been able to foresee that the economic operator will not be able to satisfy its liabilities when due.*"

In the first scenario, the controlling shareholder has majority votes, therefore, the decisions of the supreme body are heavily influenced by him, and they are dependent on his approval. As most national laws require simple majority in the supreme body for most decisions, a majority shareholder may easily decide over many important questions on his own. This dominant position makes him a sole shaper of the company's strategies, and he may also be the one who can appoint or fire directors at will without the obligation to obtain consent from other shareholders. In the second scenario, the controlling shareholder has either *de facto* or *de jure* dominance over the managers of the company, so the directors act as for the order of the controlling shareholder. In such cases, the controlling shareholder's liability may be similar to the director's liability as the nature of their actions are comparable to the activities of the managers. Directors of the company must be loyal to the company, and it imposes the fiduciary duty of managers to serve the best interest of the company. Typically, the company's interests come at first, and not the shareholders'. In practice, except for the specific cases of insolvency, the company's interests may be very similar to the shareholders' interests. The shareholders, as a group, form the company, so the director's fiduciary duty can be interpreted as a duty toward the shareholders. National laws list various duties under the general scope of the fiduciary duty of the director, like the duty to fully disclose the conflict of interest and to obtain the shareholders' approval in case there is a transaction between the company and the director. It also means that the breach of this duty may result a void transaction, and the breaching director will be liable for the profit he/she made under the transaction and for any loss the company might have suffered from the transaction. Some legal systems also entitle the company to recover damages from the third party as well.<sup>24</sup> Another angle of the director's fiduciary duty is that they bear individual liability for the consequences of their decisions toward the company. It requires directors to act using reasonable skill and care that presumes some professionalism at their end. While shareholders may be treated as lay investors, directors cannot use the defense of being a bystander as their duty toward the company involves a professional standard of care. Legal systems provide various solutions to the problem on how to treat the liability of the controlling shareholder. English company law steps up with the concept of the shadow director. The shadow director is "a person in accordance with whose directions or instructions the directors of the company are accustomed to act".<sup>25</sup> This definition suggests that the act of the shadow director must amount to directions and instructions and must be intentionally influential to the activities of the *de jure* directors. While the definition of the shadow director is not that exact in Germany and Estonia, these civil law legal systems admit that in such cases the controlling shareholder's liability must be similar to the *de jure* director's.<sup>26</sup> While a shadow director is not necessarily a controlling shareholder, in practice, he most likely holds a controlling block in the company. Once a controlling shareholder meets the requirements of a shadow director, English, German and Estonian company laws burden him with the same liability as for the *de jure* directors. The real conflict in this situation is that supreme body of the company has a right to decide on actions against both the *de jure* directors and the shadow director. As it seems obvious that a controlling shareholder would never vote against himself, the supreme body may fail to take actions, English law created the category of derivative action when an individual shareholder can sue in the name of the company. Civil law legal systems (e.g. Germany and Estonia), however, take procedural boundaries more seriously, therefore, derivate actions are not available solutions there. Therefore, most civil law legal systems order that a controlling shareholder cannot vote in such cases, and the majority shall be counted

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<sup>24</sup> United Kingdom, Section 260(3) of Company Act 2006.

<sup>25</sup> United Kingdom, Section 251(1) of Company Act 2006.

<sup>26</sup> Germany, Article 117(2) of the Stock Corporation Act 1965 (AktG); Estonia, Article 167(1) of the Commercial Code 1995.

among the other shareholders.<sup>27</sup> The controlling shareholder is not a bystander in these cases, therefore, his biased vote will not count. While this special form of shareholders' liability puts an increased level of vigilance on the controlling shareholder, we have to emphasize that even in these cases, the general conditions of liability must also be met. It is important to stress as in the fault-based liability regimes, the malicious, fraudulent intent of the shadow director must be proved in order to impose liability on him. It, however, may be an interesting scenario if the national law imposes strict, no-fault based liability on the directors for the damage they cause to the company. Hungarian law is a great example to this setting. The new Hungarian Civil Code says very little about the liability of directors as it refers to the rules of liability for damages for loss caused by non-performance of an obligation.<sup>28</sup> These latter rules impose strict liability to the breaching party, therefore, fault is irrelevant when deciding over the liability. As the new Code is quite young, judicial practice has not had a chance to further interpret how these rules on liability for non-performance of a contractual obligation should be applied in cases when a company director breaches his fiduciary duties, however, unless the breaching party successfully proves that unforeseeable circumstances beyond his control served as an impediment and that caused the breach, he is held liable for the damages in a no-fault system. As a derivative of the rules, we may say that in Hungary, a controlling shareholder who acts as a shadow director may be liable for any loss the company suffers as a consequence of improper management activities, disregarding his fault. It also implies that the *de jure* directors may be jointly and severally liable together with the shadow director for such damages. We do not believe that the *de jure* directors can easily defend themselves by referring to the fact that their actions were instructed and controlled by the shadow director (controlling shareholder), as their loyalty and fiduciary duty is toward the company and not one of its shareholders.

## VI. Shareholders' liability in the European Union

In 2007, the European Union's Council and the European Parliament adopted a Directive on the exercise of certain rights of shareholders in listed companies (Shareholder Rights Directive).<sup>29</sup> The Directive lists a series of rights granted to shareholders in listed companies, mainly in relation to their voting rights and rights to information. The Directive does not, however, cover the issues of liability of shareholders, while other bits of EU legislation contain small traces of the problem. The EU Directive on single-member private limited liability companies<sup>30</sup> sets an obligation that the fact that all shares of the company is held by a single person along with the identity of the sole member must either be recorded in the file or entered in the company register in the Member States.<sup>31</sup> This provision ensures that creditors will get proper information about the company being controlled by a single shareholder, therefore, it is much easier to enforce the rules enacted for the cases of shareholder liability against the only member of the company, even if these cases of liability are listed in the national laws of the Member States. Still, none of the so-called company law directives contain clear liability rules against the shareholders, we may only find such situations established in the national laws. The company law related norms of the European Union have not moved to the direction when shareholders must act with due diligence and must prevent the company from getting insolvent. EU law does not impose clear fiduciary duties on the shareholders, it still focuses on the

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<sup>27</sup> Hungary, Article 3:18 of the Civil Code 2013.

<sup>28</sup> Hungary, Article 3:24 of the Civil Code 2013.

<sup>29</sup> Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies.

<sup>30</sup> Directive 2009/102/EC of the European Parliament and of the Council of 16 September 2009 in the area of company law on single-member private limited liability companies.

<sup>31</sup> Article 3 of Directive 2009/102/EC of the European Parliament and of the Council of 16 September 2009 in the area of company law on single-member private limited liability companies.

management-shareholder relationship where shareholders must be armed against the autonomous activities of the directors, therefore, rights to provide sufficient information about the company's operation to the shareholders are the main concern.

In April 2014, the European Commission presented a proposal for the revision of the Shareholder Rights Directive to tackle corporate governance shortcomings related to the behavior of companies and their boards, shareholders, intermediaries and proxy advisors.<sup>32</sup> The proposal aims to strengthen shareholder engagement in listed companies in order to make them more focused on the operation of the firm instead of being just simple investors. The proposal states that too often, shareholders support managers' excessive short-term risk takings and do not monitor closely the companies they invested in. The proposal specifically mentions the lack of shareholder oversight on related party transactions as a source for the problem. According to the proposal, related party transactions cover transactions between a company and its management, directors, controlling entities or shareholders. These transactions typically create the opportunity to obtain value belonging to the company to the detriment of shareholders, especially minority shareholders, therefore, they impose a huge risk on the solvency of the company.<sup>33</sup> The proposed rules would require listed companies that related party transactions representing more than 5% of the companies' assets or transactions which can have a significant impact on profits or turnover to submit these transactions to the approval of shareholders and may not unconditionally conclude it without their approval.<sup>34</sup> The proposal, however, aims to provide more rights to the shareholders, and plans to establish new obligations to the directors before engage the company into certain transactions. Failing to comply with the proposed rules would result liability for the directors, while the proposal does not cover the scenario when the shareholders abuse with these new rights and let a problematic and harmful transaction pass. We can see that EU law does not cover the problem of shareholders' liability, so these questions are settled by national laws in very diverse ways.

## VII. Summary

The concept of limited liability of the shareholders in a limited liability company started to erode from the moment the principle was established in order to cure the negative effects of the limited liability doctrine in company law. At first, the legislator only focused on clearly fraudulent and malicious behaviors of the shareholders in order to penetrate the protective corporate veil and allow creditors and third parties to carry out a lawsuit against the shareholders in a limited liability company. These days, company law has to fulfill various interests. On one hand, it has to ensure that its flexible enough to boost economy and urge the formation of companies in a country by both nationals and foreign investors. On the other hand, company laws must be secure and certain enough in order to offer safeguards and protection to the creditors, minority shareholders, employees and in some cases the members of the society. Corporate governance became an issue worldwide only in the last couple decades. This phenomenon does not only focus on the directors/managers of the companies but to the shareholders in the company burdening them with a more vigilant overseeing obligation over

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<sup>32</sup> Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement.

<sup>33</sup> Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement Explanatory Memorandum point 2.

<sup>34</sup> Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement. Legal Elements of the Proposal no. 3.

the management and the activities of the company. The European Union has not moved to the direction of creating clear cases of shareholder's liability and to the direction of burdening shareholders with controlling obligations. Therefore, there is no general standard for the shareholders on what grounds they may be found liable for the company's debts or in case of corporate torts. Still, certain situations may find the shareholders in a position when they have to face an increased level of duty of care and act as directors burdened with clear fiduciary duties. These situations are typically linked to the problems of controlling shareholders who often act as shadow directors, or shareholders in a dominant position overseeing and controlling a group of companies. While we do not suggest that shareholders have to bear a general liability for the misconduct of the company towards third parties, the new trends in corporate governance certainly claim for an increased and more precise list of the duties of the shareholders. The investor/shareholder position comes at many advantages in a limited liability company. Still, it should have its obligation side as well in order to establish a responsible behavior of companies toward the members of society and actors of the economy as well.