Course: Master's Paper

Corporate Responsibility Implications: Good Faith and Business Risk

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Introduction

Business is a phenomenon that cannot go forward without conscious business risks presumed. Those risks taken are the main justification of the profit gained. Nevertheless, not always it is the case when risks justify themselves: they can also inflict losses to a company. And here is when corporate responsibility issues can arise for those who are called to take business risks. Different jurisdictions use different approaches to the issues of corporate responsibility when business risks taken in good faith resulted in losses for a company. This paper will do justice to the US experience of corporate responsibility, and stress its attention towards corporate responsibility implications in Armenia. The US has chosen the phenomenon called Business Judgment Rule to be critical for its model of corporate governance and responsibility. This phenomenon is called to protect from liability those who take risks, thus encouraging them to act and serve in the best interests of company shareholders. The connotation behind this guarantee is that no reasonable director would agree to serve for the sake of shareholders benefit, when the fear of personal liability is at stake. Armenian corporate reality being in its initial stages of formation has not yet established a corporate culture, which would uncover whether Armenian legal framework and existing business practice properly regulate directors' freedom of taking business risks and guarantee exemption from liability in case those risks were detrimental to a company.

In this paper we intend to study the position of the BJR in the corporate governance system of the US. The first part provides an overview of the history, evolution and essence of the BJR. The second part of this paper will discuss the regulation of corporate responsibility in Armenia revealing the connotations, as well as the gaps of the law and existing business practice with regard to corporate responsibility. It will also stress on the ways eliminating those gaps and formulating clear, precise and unconditional regulations of the law, guaranteeing directors' ability to resort to business risks and be exempt from liability for the losses those risks may incur.

Chapter 1. BJR: Ideal perception of the American corporate system!?

Evolution, History and Concept of the BJR

Business Judgment Rule (hereinafter BJR) is the "golden rule" of the American corporate law and governance[1]. It has been part of the common law for at least 150 years[2]. The peculiarity of the BJR is that it is not statutorily codified: it has been and remains a jurisprudential tool, a judicial presumption. The roots of this doctrine go back to 1829 when in *Percy v. Millaudon* the Louisiana Supreme Court emerged a test of responsibility[3], pursuant to which:

"[T]he occurrence of difficulties... which offer only a choice of measures, the adoption of a course from which loss ensues cannot make the [director] responsible, if the error was one into which a prudent man might have fallen. The contrary doctrine seems to us to suppose the possession, and require the exercise of perfect wisdom in fallible beings. *No man would undertake to render a service to another on such severe conditions... The test of responsibility, therefore, should be, not the certainty of wisdom in other, but the possession of ordinary knowledge; and by showing that the error of the [director] is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it"*. [Emphasis added].

This case was the starting point for the BJR to emerge, though since than it has developed, and now includes some new additional features rather than reasonableness[4], which will be discussed below. Nowadays, the concept of BJR as stated in *Aronson v. Lewis* [473. A. 2d 805 (Del. 1984)] is as follows: "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief

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[1] Palmiter, Alan R. *Corporations.* 5th ed. New York, Aspen Publishers, 2006, 201.
[2] Ashraf, Zeeshan. "The Position of the BJR in Different Corporate Cultures and Structures: a Study and Analysis". *Institute of Comparative Law, Montreal.* 2006, 5.
[3] [8 Mart. (n. s.) 68 (La. 1829)]
[4] Ashraf, 5-6.

that the action taken was in the best interests of a company"[5]. So, the business judgment presumption is called to protect directors' decisions.

The BJR includes two perceptions: 1. it shields directors from personal liability, and 2. it escapes directors' decisions from judicial review: the latter perception is also known as the "business judgment doctrine".[6] The essence of this presumption is that not only directors, but also their decisions need protection. So, the BJR protects the directors themselves, while the business judgment doctrine protects the directors' decisions although the BJR and the business judgment doctrine are not separate notions, they are interconnected and there is no need to differentiate them[7].

The essence of the BJR is that it "bans" courts from scrutinizing the substance of directors' decisions: in order to determine whether a director has acted in due care in his decision-making capacity only the adherence to the procedural requirements is taken into account by the courts when considering the possibility of director liability[8]. As it can be considered from the aforementioned, Courts and Judges are reluctant to overcome directors' decisions even if they were not beneficial for the company. The reason for this is the existing presumption that directors are more qualified to make business decisions than judges are[9]. As it is stated in the *Joy* Y. *North*[10] "after-the-fact litigation is the most imperfect device to evaluate corporate business decisions".

So, as already discussed, the Courts in deciding whether a director should be held liable for its decisions detrimental to a company, take into account mainly the adherence to the procedural requirements of a director's decision-making. The business judgment is protected only when a business decision is deliberately reached, i.e. directors in reaching their decisions first follow adequate procedures. For example, directors should properly inform

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[5] Reda James F., Reifler Stewart, Thatcher Laura G., *Compensation Committee Handbook*, John Wiley & Sons, Inc., Haboken, New Jersey, 2008, 93.
[6] Palmiter, 203.
[7] Ashraf, 13-14.
[8] Stout, Lynn A. In praise of procedure: An economic and behavioral defense of *Smith v. Van Gorkom* and the BJR. *UCLA, Research Paper series, no. 01-21,* 2001, 3.
[9] *Federal Deposit lns. Corp.* v. *Stahl* (1996), 89 F.3d, 1510 (11th Cir.).
[10] (1982) 692 F.2d 880 (2d CiL).

themselves in their decisions: consult experts on matters beyond their own competences. The Delaware Supreme Court stated: "Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decision-making context is process due care only". (*Brehm v. Eisner*, 746 A.2d 244, 264 (Del. Supr. 2000))".[11]The most illustrative case which focuses on the procedural essence of the BJR and one of the few cases where courts had shown their willingness to subject directors to liability is *Smith v. Van-Gorkom* [488 A. 2d 858 (Del. 1985)]. In the said case the Delaware Supreme Court imposed liability on the directors of a public corporation for approving the acquisition of their corporation at a considerable premium over the market price, mainly because directors were inattentive to the possibility of better offers from third parties. The essences of the Court's holding was that the directors could not claim the protection of the BJR, because they did not inform themselves or consult experts' advice when deliberating their decision[12]. "Even though a decision made or a result reached is not that the hypothetical ordinary prudent person would reach, no liability will attach as long as the decision-making process meets the appropriate standard".[13]

And here is the said standard: the court found in *Brehm v. Eisner*[14] "directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose, or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available". So, the BJR shifts from liability those directors who act in good faith, on an informed basis, free from conflict of interest, and on a presumption that decisions are based on a rational business purpose.[15]

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[11] Klein, William A., Coffee, C. Jr. *Business Organization and Finance: Legal and Economic Principles,* 9th ed., Foundation Press, New York 2004, 155-156.
[12] Klein, William A., Ramseyer, Mark J. *Business Associations*, Westbury, New York, The Foundation Press Inc., 1997, 301-317.
[13] Macey, Jonathan R., O'Hara, Maureen. "*The* Corporate Governance of Banks", *FRBNY Economic Policy Review*, April 2003, 3.
[14] [746 A.2d 244, 264 n.66 (Del. 2000)]
[15] *In re Caremark International Inc. Derivative Litigation*, 1996 WL 549894 (Del. Ch. 1996), the Court stated that "whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director

Therefore, the whole business judgment presumption becomes useless when directors do not act in good faith in a particular course of conduct. What is “good faith”? “Good faith” is the main feature of the duty of care which directors of a company owe to shareholders. The “good faith” standard includes: 1. directors’ honesty, 2. their not having a conflict of interest, and 3. not approving wrongful or illegal activity[16]. The “honesty” standard requires that directors do not act fraudulently, e.g. when directors knowingly or recklessly misrepresent a material fact on which the final decision is to be based and which is to the detriment of the company. As to the “illegality” standard, when directors act illegally the business judgment presumption is lost even if directors were informed and their actions benefited the company (for example, bribery of governmental officials for easily gaining some advantages).[17]

In order to illustrate the essence of the “conflict of interests” standard, i.e. when a person’s (director’s) self-interest conflicts with those of others (shareholders’), a “prisoners’ dilemma” of game theory will be succinctly presented. In the case of a “prisoners’ dilemma”, players must choose between “cooperating” or “defecting”[18]. When choosing to defect, each player maximizes its own wealth. In case when all the players choose to cooperate, they maximize their total gain. And this is the case with the directors having personal interests in a company transaction. Of course, for a “selfish” director it would be better to appropriate all that transaction benefits. But for a reasonable director acting in due care, it is always the best solution to act in the interests of the company rather than his own. What helps directors be more altruistic is the deterring effect of the business judgment presumption and the fear to lose all the benefits the said presumption implies.[19] It seems that the rationale behind is that, directors should understand that they are hired to act only and only to the benefit of the corporation and its shareholders Once they decided to be “selfish”, it will only be to their detriment, because it is themselves that would be deprived of the BJR’s protection and be

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liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests.”

[16] Palmiter, 202.

[17] *Ibid.,* 206.

[18] Stout, 16.

[19] For more details about social dilemmas, see *Ibid.,* 14-29.

subjected to personal liability. As to the shareholders, they always have an option of choosing other disinterested (those who have no financial interests in a transaction) directors. Hence, this reasoning leads to an assumption that it is always better for directors to cooperate with shareholders, rather than to act alone, and carry all the negative consequences of their acts alone.

It has already been discussed that in order to use the BJR as a shield from liability, directors' actions should be attributed to a rational business purpose. As stated in *Sinclair Oil Corp. v Levien*[20], "the "business judgment" of a majority of the directors "will not be disturbed if they can be attributed to any rational business purpose". When challenging the rational business purpose, the challenger should prove "waste" of the corporation's assets. Courts are reluctant to define what rational business purpose is and what the absence of it implies. The only case Courts would prove corporate waste is when the transaction was of no benefit to the corporation (e.g. when the directors used corporate funds to fulfill their personal obligations).[21] As already discussed, the rationale for Courts' such attitude towards directors and their decisions is that they are eager to find company directors acts good-faith actions, unless "corporation's best interest is so removed from realm of reason" or "director's belief so unreasonable as to fall outside bounds of sound discretion"[22], thus once again proving that Courts are reluctant to second-guess the substance of directors' decisions.

In order to rebut the business judgment presumption, the challenger should prove not the standard of simple negligence, but rather what is called gross negligence. In *Sinclair Oil Corp. v Levien*[23], the court found that "gross negligence would appear to mean 'reckless indifference to or a deliberate disregard of the stockholders", or likewise, in *Allaun v*

[20] 280 A.2d 717, 720 (Del. 1971). Likewise, in In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 74 (Del. 2006) the Court found: "[W]here the business judgment [rule] presumptions are applicable, the board's decision will be upheld unless it cannot be attributed to any rational purpose."

[21] Palmiter, 207-208.

[22] Official Comment, MBCA, para. 8.31 (a) (2) (ii).

[23] 280 A.2d 717, 720 (Del. 1971).

Consolidated Oil Co.[24] the court by saying gross negligent actions meant those which are "without bounds of reason".

So, it can be implied that although *Smith v. Van-Gorkom*, as one of the most important cases illustrating the essence of the BJR, concentrates mainly on the procedural failures of directors' decision-making, in order to use the BJR as a shield from liability it should be clear that directors act in good faith, do not have conflicting interests and act in the direction of a rational business purpose.

In his thesis paper referring to "*Business Judgment Rule: Fiduciary Duties of Corporate Directors*" (Dennis J. Block, Nancy E. Barton, Stephen A. Radin) the author offers various rationales justifying the BJR[25]. Below each of them will be discussed briefly:

1. **Human Fallibility**:

The presumption under this rationale is that even reasonable and prudent persons can make mistaken judgments[26] which can be detrimental to a company. The BJR guarantees such persons' exclusion from personal liability, thus encouraging them to promote the company's growth and prosperity without fear.

2. **Importance of Taking Risks:**

Business is a sphere where nothing could be achieved if no risks are taken by directors in their decision-making. No director will be eager to take risks, if the fear from liability exists.[27] It seems that the real nature of the BJR is fairly illustrated in a famous adage – "nothing ventured, nothing gained"[28]. As the author truly states in his thesis paper: "absence of risk-taking is detrimental to the economy as a whole, inasmuch as dynamic changes are the most powerful engines of efficiency and growth"[29]. It can be considered from the aforesaid, the BJR is called to encourage directors to take reasonable risks, because without risk the business will never go forward.

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[24] (Del. Ch. 147) A. 257, 261 (1929).
[25] Ashraf, 11.
[26] *Washington Bancorp.* v. *Said,* 812F. Supp.1256 (D.D.C. 1993).
[27] Ashraf, 11.
[28] Palmiter, 204.
[29] Ashraf, 12.

3. Court's Inability:

It is already a fixed presumption in the US case law that because directors are more qualified and trained in business matters than judges are, when deciding cases involving business decisions, judges are most likely reluctant to enter into the areas of the business world they are not familiar with[30]. It is very amazing to realize that the American system of business governance is so developed, self-organized and self-correcting mechanism that judges leave the discretion as to the substance of business decisions to directors themselves without any doubt and fear that their knowledge and proficiency would somehow hinder the prosperity of a company.

4. Prevention of abusive shareholder litigation:

It is not uncommon that shareholders do not approve directors' decisions unanimously. There are often "dissenting shareholders" willing to challenge decisions in courts. In case every decision is examined by the court it will have a negative impact on a directors' decision-making capacity, and they will become easily wounded targets of shareholders. The role of the BJR is to ensure that directors who represent majority shareholders and not the "angry ones" manage the corporation. All this is justified, because the American corporate governance system is wholly directed to the shareholder wealth maximization, and it would be unfair to subject honest directors to litigation processes when they actually acted in good faith and in the best interests of the shareholders of a company.

5. Availability of other remedy

Even though the BJR protects reasonable and honest directors from personal liability, the shareholders are always free to vote out the mistaken director from a company's management[31].

So, it can be concluded from the aforesaid, that discretionality of directors in the field of business decisions should be protected. This is best achieved by the phenomenon called "Business Judgment Rule", which ensures the removal of the field of business decisions from

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[30] *Ibid.*

[31] *Hilton Hotels Corp. v. ITT Corp.,* 978 F. Supp. 1342 (D.Nev. 1997)

legal, judicial scrutiny. The reasons for this are: 1. there is no consolidated set of legal standards to which judges can refer to when judging business decisions; 2. Judges are not qualified and proficient enough to judge business decisions, and, thus, it is not justified to substitute business decisions for legal ones; and 3. there is a risk of judicial bias because when the outcome of a decision is detrimental to a company, the cause and fact of reaching the decision may be assumed.[32] The strong adherence to the presumptions of the BJR is also justified by the fact that directors' performance is a high risk work. Even when losses are suffered as an outcome of a director decision, the reasons should be attributed to other factors rather than a director's poor management. The reason is that directors (especially when they are also shareholders) are the first to be interested in the economic prosperity of a corporation: economic success implies taking risks when making business decisions, because they are the main justification of the profit gained.[33]

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[32] Tully, S., *Research Handbook on Corporate Legal Responsibility,* Edward Elgar Publishing Limited, Cheltenham, UK; Northampton, MA, USA, 2005, 66.
[33] Ibid.

Chapter 2. The Regulation of Responsibility of Directors in Armenia

Part 1. Corporate Responsibility: Connotations of the Law

After having discussed the main features of the American corporate system regarding the business judgment presumption, this paper is now going to try to reveal the characteristics of the corporate governance system, mainly its attitude towards corporate responsibility, in Armenia. As a country being in its transitional phase of development, it is obvious that business development is also in transition. Corporate culture has not yet developed in Armenia, and that is why it is better and easier to try to construct business in the comparably best possible way now, when the traditions are not yet rooted.

Unlike Anglo-American legal order countries, Armenia, as a country of a Franco-German legal system, regulates its corporate relations via laws. Nevertheless, even the presence of a law regulating any field of public relations is vein if there is no any interpretation of the law reflecting the pros and cons of its practical application, its correspondence to the practical needs of a country. The main law regulating corporate responsibility issues in Armenia is the RA Law on Joint Stock Companies (hereinafter-the Law).

Bearing in mind that business is one of the main sources of economic development of a country, the regulation of effective corporate governance and director responsibility should be a priority for the State. It should be of crucial significance for legislative and judicial branches of the state power especially to adopt and interpret the Law in a way it has its valuable contribution to the public relations it is called to regulate. The vague and imprecise language of the Law and the absence of its interpretation lead to a situation that each business decides for itself how and on what basis subject directors to corporate responsibility or, as the case in Armenia is, subject at all or not.

Corporate responsibility issues are not properly regulated in the Law and there is no any scholarly research conducted, and there is no any rich case law and court interpretation on this. In a given situation nothing is left than trying to analyze the law and finding out whether the interpretation of the Law on JSCs allows for such an assumption that business risk is

considered as a ground releasing from liability corporate directors who act in good faith, in the best interests of a company even if their actions may be detrimental to the company.

In an attempt to finding out whether corporate directors should be held liable for their actions conducted in good faith but detrimental to the company, a hypothetical fact-pattern will be introduced and analyzed from the perspective of a reasonable prudent person:

Assume an outside disinterested director entered into a transaction with a company abroad and sold "x" number of his company shares to the said company operating abroad. The director did not have any conflict of interest in the transaction and he acted in good faith with a view to gaining profit for the company. The transaction price was considerable, and was to be paid in foreign currency. Before signing the contract the director asked the board to determine the market value of the shares, explored the currency market, consulted with experts about possible fluctuations of that currency, informed and consulted the board, and only then signed the contract. After the transaction price was paid, financial crisis suddenly broke up: the foreign currency fell down dramatically, and resulted in losses for the company.

It is Article 90 of the Law that regulates the responsibility of company directors. Pursuant to the said article:

1. The Company's Board members, the director (general director), the members of the executive and management boards, as well as the management organization and the manager shall act on the basis of the Company's interests, exercising their rights and performing their obligations in regards to the Company in good faith and in a reasonable manner.

2. The Company's Board members, the director (general director), the members of the executive and management boards, as well as the management organization, the manager, and other persons defined by law shall be liable to the Company for the damage caused to the Company by their actions (inaction), in the manner stipulated by the Code, this Law, the RA Law "On Securities Market Regulation", and other laws. Liability for damage caused to the Company shall not apply to those members of the Board or the executive and management

boards, who either voted against the decision causing damage to the Company or did not participate in the respective session.

Resignation, dismissal, or firing of the Company's Board members, the director (general director), or the members of the executive and management boards shall not exempt them from liability for damage caused to the Company.

When determining the grounds for and size of liability of the Company's Board members, the director (general director), the members of the executive and management boards, as well as the management organization and the manager, one **shall take into account business practices and other factors of importance to the business.**

3. If several individuals are liable for damage caused to the Company, as defined under this Article, then they will be commensurately liable to the Company.

4. An individual shall be exempt of the liability for damage caused to the Company, as defined under this Article, if he/she acted in good faith, i.e. did not or could not know that his/her actions (inaction) would cause damage to the Company.

5. The Company or a shareholder(s) thereof, who (which together) possesses (possess) one or more percent of the outstanding ordinary (plain) shares of the Company may sue the Board members, the director (general director), the members of the executive and management boards, as well as the management organization and the manager in court, claiming compensation for damage caused to the Company.

For a reasonable judge to be able to find out whether the outside Director whose decision to sell the company shares resulted in losses for the company, would be held liable or released from liability in the realm of the Law, a thorough analysis of Article 90 needs be conducted.

First of all, as can be considered from the wording of the 1st part of the article, Armenian corporate model focuses on company wealth maximization rather than shareholders'. Company directors should act *in the best interests of the company*, in good

faith and in a reasonable manner[34]. From the first glance it seems that the Armenian law gives the basic components of due care (discussed in the first chapter), exercising which a director should be exempt from liability. As already discussed, there is no any literature, any interpretation of the law, any case law in Armenia which could help define what it is to say reasonable manner and good faith in terms of corporate responsibility, and whether they imply taking business risks, and which would serve as a ground releasing from responsibility. When speaking about reasonable manner, the Legislature might meant the adherence to the procedural aspects of directors decision-making, i.e. whether the decision was informed, whether the director conducted appropriate and thorough investigation and/or considered the possible alternatives to his decision.

After discussing the essence of "good faith" in the American perspective of directors' liability, it is concluded that acting in good faith, i.e. honestly, without having a conflict of interest and without engaging in an unlawful illegal behavior, at the same time consciously assuming risks, the director is exempt from liability. In the Armenian Law there is no any clear cut definition of what good faith means and whether it also implies business risks as a main feature of undertaking business activities.

In an attempt to finding an answer to this question, interviews were conducted with many experienced practicing lawyers, law professors, judges and businessmen in Armenia. What was amazing is that no one precisely explained what good faith means, what elements it includes, and each of them had its own understanding of the essence of good faith. So, below will be briefly presented perceptions of the professionals interviewed about what good faith implies. Mr. A. Kakoyan, a partner and director of the "Investment Law Group" LLC, said that it is very easy to find out whether a director acted in good or bad faith, because the border

[34] As the CEO of an IT company operating in Armenia (who did not want me to disclose the company's name in my paper) said that it is a correct policy of the Law to concentrate on a company rather than shareholder interests and wealth maximization. The reason is that "n" number of shareholders join together to reach a common goal, and in the process of realizing that goal it would be very difficult and unreasonable to coordinate all and each shareholders' interests.

separating these two concepts in clear and precise[35]. It may be the case because what is bad faith can be fairly established when a director acted having a conflicting self-interest in a particular transaction, e.g. he wasted a big amount of corporate funds just because he wanted to obtain a new luxurious car. Nevertheless, in more complicated business practices it is not that easy to make a distinction between good and bad faith. As Mr. Kakoyan further explained, the features of good faith are very subtle and in the absence of its regulation in the law, it is left to the judges' interpretation. On the other hand, there is no such interpretation, because the question of responsibility rarely arises if arises at all in Armenian corporate reality (the practical implications of corporate responsibility will be elaborated on further).

Another understanding of good faith derived, as it seems from the former, is that whether Armenian judges are proficient and qualified enough to determine what reasonableness and good faith mean[36].

The founder and the general director of the "ESCo Concern" CJSC, Mr. S. Aghabekyan, told that in his view "good faith is not a legal category/concept, rather it is a subjective one to be decided by a judge or an expert's professional conclusion or statement"[37].

The vague and imprecise language "escorts" also the second part of the discussed article. Its meaning is that directors are liable for their actions/inaction which caused the company to suffer losses. What kind of actions or inaction are these? The Law does not define whether these actions/inaction are intentional or a result of a director's negligent or reckless conduct. So, does the Law imply those which are fraudulent, undertaken in an unreasonable manner or bad faith (e.g. the bases for the action/inaction were conflicting interests), or just vice versa, actions/inaction, which were undertaken in good faith but resulted in losses for the company, thus leading to the exclusion of assuming business risks? The last paragraph of the second part of Article 90 seems to answer this dichotomy, but when reading it in depth, controversy goes deeper. So, pursuant to the Law, as already stated above, for determining

[35] Kakoyan, Artashes. Personal Interview. 20 January 2011.

[36] Bekmezyan, Grigor. Associate Professor,Faculty of Law, YSU, Chief Legal Counsel, NASDAQ OMX, Armenia. Personal Interview. 24 January 2011.

[37] Aghabekyan, Sargis. Personal Interview. 15 February 2011.

grounds and size of directors' liability, business practices and other factors of importance to the business should be taken into account. Does this wording of the Law mean that Armenian Legislature tried to somehow regulate business judgment presumption in this vague, imprecise and conditional language of the article? It is another issue that corporate business is not that developed in Armenia and business practices have not yet fully established. In the absence of interpretation of these provisions, one can engage in twofold understanding of them, on the one hand supposing that a director should be held liable in any case his actions or inaction were to the detriment of the company without considering the underlying business judgment presumptions, on the other hand, presuming that a director would not be held liable if he acted recognizing the rules of business, mainly the importance of taking risks, at the same time acting in good faith and reasonable manner.

Now turning to the analysis of the forth part of the article, it seems the most controversial one, despite its precise and unconditional wording. Its wording presumes that directors are exempt from liability when they act in good faith, i.e. they did not or could not know that their actions would be detrimental to the company. Does this mean that the law gives the notion of good faith: did not or could not know, thus, limiting directors' ability to act in the best interests of a company only to the extent that they know or should know what the outcome of their reasonable actions may incur? Following the article's language, we can assume that this wording precludes the assumption of taking business risks, and that business judgment presumption is simply excluded from the scope of the Armenian corporate governance and responsibility. Can this be the case when business will never go forward, never prosper and develop without any deliberate risks taken? Will ever directors dare taking a reasonable risk bearing in mind the fear of possible personal liability?

On the other hand, as Mr. G. Bekmezyan explained, this part of the Article is very narrow and precise, and one should not engage in such a strict interpretation of its wording as to simply excluding any business judgment presumption from the scope of its application. What his perception presumes, is that the wording of the forth part of the Article clarifies that

good faith, in a sense that a director did not or could not know that his actions might be detrimental to the company, serves as a guarantee for exempting from liability the erred director at the same time not excluding other implications of good faith exempting from liability, including the business risk.

Considering this, it can be fairly concluded that the Law has such a vague and conditional language that its interpretation brings to opposite presumptions of the same concept which exclude one another. So, in assuming the discussed perspectives of the forth part of the Article one may reach a deadlock on the one hand reasonably inferring that Armenian corporate model excludes business judgment presumption and its composite business risk as a basis for exempting from liability conscientious directors, on the other implying just the opposite: that this part is just a guarantee stressing the exemption from liability without compromising the implication of other elements of good faith as releasing from the said liability.

Finally, the last part of the article vests the company itself or its shareholders who jointly or severally possess one or more percent of the outstanding shares of a company to sue the erred directors claiming to reimburse the damages suffered by the company. That Armenian corporate model is concentrated on a company's rather than shareholders' interests prioritization is proved by the fact that the company itself can claim for director responsibility.

When applying the regulations of Article 90 to the hypothetical case presented above it can fairly be considered that a reasonable prudent person cannot determine whether the Director of a company acted in good faith or whether he should be exempted from liability based on the regulations of the Article. The Director's actions resulted in losses for the company; he assumed the possibility of losses, i.e. the risk of possible losses, at the same time he acted in the best interests of the company with a view to gaining profit, and in reasonable manner.

The logic and the wording of different parts of the Article do not allow to render a reasoned judgment and to conclude unambiguously whether the Director should or should not

be exposed to liability for the losses suffered by the company as a result of the transaction authorizing the sale of company's shares. The managing partner of the "Prudence: Legal Advisory and Counseling" CJSC, Mr. E. Mouradian fairly noted that when determining corporate responsibility issues, Article 90 cannot serve as a proper basis and guarantee with its vague, imprecise and contradictory wording[38].

Aforesaid leads to the conclusion that the Law regulating corporate responsibility issues has many gaps. It is not obvious from the wording of the Law whether those listed in the first part of Article 90 are to be held liable only in cases when they acted intentionally or the Law also presumes negligence and/or recklessness as bases for liability. If the Law presumes not only intentional actions/inaction, but also negligent or reckless ones than it excludes conscious taking of business risks from its application[39]. It is not also clear what is to say good faith and reasonable manner, and whether the adherence to these concepts would release directors from personal liability. In responsibility cases especially, the policy of the state and the legislature should be that the Law precisely "informs" people about their rights and obligations in order for them to be able to conform their behavior to the requirements of the Law. Stated another way, the law should be of a quality as to assure that acting in a particular way incurs liability, while choosing to act the way regulated by Law, a person is exempt from liability.

Armenian legal system has a law of such a quality which regulates responsibility of bank managers. Banks constitute only one segment of corporate activities in Armenia, and the policy of the Legislature was to precisely regulate responsibility of bank managers. The rationale behind this may be the role banks have in the governance of other types of companies. Duties of bank managers should not run exclusively to banks' shareholders. Banks also owe duties to companies they are called to service. That is why directors and officers of

[38] Mouradian, Edward. Personal Interview. 11 March 2011.

[39] In contrast, in the American model a question of responsibility rises only when directors acted in a grossly negligent manner, thus strengthening directors' ability to resort to risks for the sake of shareholders without fearing to be exposed to personal liability.

banks should be charged with heightened duties not only to their shareholders but also to those corporations[40]. Pursuant to Article 60.1 of the RA Law on Banks and Banking:

1. The bank managers shall perform their duties resting upon bank's interests, they shall perform their rights and obligations towards the bank bona fide and sensibly.

2. The managers of the bank shall bear responsibility for losses that have been inflicted to the bank **due to their premeditated action (inaction)** according to the Armenian legislation. If more than one manager has inflicted losses to the bank they shall bear joint responsibility. The managers who have voted against the decision that inflicted losses or have not participated in that session shall be released from responsibility for inflicted losses.

3. **The party shall be released from responsibility to cover losses of the bank if he has acted bona fide with firm conviction that his actions rested upon the interests of the bank**. In particular:

a. if decisions have been made resting upon sober-minded logic, even if later on these decisions inflicted losses that have been considered as **business risk** while adopting those decisions;

b. if the manager has adopted wrong or imperfect decisions **being bona fide without intention to inflict losses** and if the adoption of such decisions has not infringed the law or other regulations.

The release of bank managers from their duties shall not release them from the responsibility for losses inflicted through their fault.

4. The bank or bank participant (participants) holding (jointly) 1 and more percent of bank's ordinary shares (participation in bank's statutory fund) shall have the right to bring a suit against bank managers for covering the losses of the bank.

The wording of the said article uncovers that this Law, unlike the Law on the JSCs, provides the guarantees of business judgment presumption: it precisely regulates good faith

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[40] Macey, O'Hara, 91-92.

(actions bona fide) as a basis releasing bank managers from liability. Moreover it allows for business risks to be taken without a fear of upcoming possible liability, as a feature of good faith and due management. The guarantee to taking business risks is also secured by the fact that bank managers would only be held liable for the losses inflicted to bank as a result of their intentional, premeditated actions. The rationale behind may be that losses inflicted due to business risks presumed on the part of bank managers, may be attributed to negligent or reckless conduct.

As the head of the Legal Department of the Central Bank of the RA Mr. V. Avetiqyan fairly noted, "the guarantees provided in Article 60.1 are a due basis for bank managers to perform their fiduciary duties of care and loyalty not only to bank shareholders but also to companies banks provide services with, and be exempt from liability when they act in good faith and in reasonable manner[41]. Indeed, the provisions of this article can be applied to the hypothetical question presented and serve as due bases for determining the Director's liability. Provided the stipulations of the said article, a reasonable person might find that the Director would be exempt from liability, because he acted in good faith in his business judgment to selling the company shares at the same time consciously implying the risks his decision may incur, and he did not intend to inflict losses to his company in view of acting in the best interests of the latter.

It is indeed praiseworthy to have such a law, which by its essence provides bank managers the guarantees of the business judgment presumption as to acting in good faith and assuming conscious business risks, thus encouraging them to serve for the benefit of the bank. Nevertheless, this is a law which regulates only one aspect of corporate activities and provides with guarantees only bank managers, while it would be quite fair for other constituents of corporate reality to equally benefit from guarantees business judgment presumptions imply.

[41] Avetiqyan. Varujan. Personal Interview. 12 March 2011.

Part 2. From Gaps in the Law to Gaps in Practice

The Law is not the only "impediment" of the proper regulation of corporate liability in Armenia. The practical realization of business also has got many flows. In an ideal perception the Law, considering the needs and peculiarities of the practice, dictates what the practical situation is or should be, and the practice should be in compliance with the requirements of the Law. The empirical research conducted revealed that this is not the reality in Armenian business relations concerning corporate responsibility.

In what all the professionals interviewed were unanimous is that in Armenia corporate liability issues generally do not arise, because shareholders in fact manage the company and not those listed in Article 90. Furthermore, Mr. G. Bekmezyan and the CEO of an IT company explained that the list of competences of the Board is not exhaustive pursuant to the Law[42] and the Board Members, which are primarily shareholders, can discuss and contemplate on risky decisions to be taken. In these cases, if they consider that a particular decision is risky and may (but may also not) be detrimental to the company, they would rather prefer gaining less profit, than approving the risky decision. The CEO of an IT company further elaborated that the aim of this practice is the protection of shareholders' interests, thus contradicting himself, as discussed above[43], that in Armenia corporate activity is concentrated more on a company's rather than shareholders' interests[44]. These perceptions lead to an implication that there is no separation of ownership and control in Armenia: shareholders own, the Board, i.e. again the shareholders, decides. So, that the Board may decide not to act and not to take reasonable risks, also comes to prove the reason of absence of corporate responsibility practice in Armenia.

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[42] RA Law No. HO-232, on "Joint Stock Companies". Adopted 25.09.2001, Article 84, Part 1, point "y".
[43] Supra, 12.
[44] The assumption in this regard is that contradiction in the words of the CEO arose, because the field is not properly regulated by the Law. There are no any common standards set by the Law regarding corporate liability issues. That is why in Armenian business world the tendency is that businessmen put aside the Law and regulate their businesses in a way they feel it to be the right way. I reached this conclusion when after all the interviews conducted I realized that those who are called to lead the company even did not know what the stipulations of the Law are regarding corporate liability issues.

Those interviewed were unanimous also in their views that in Armenian corporations there is mainly one big shareholder (who can possess up to 100% of a company's shares) who manages the company de facto. In this cases even if an outside director responsible for day to day activities of a company is appointed, he acts under the instruction of a shareholder(s)[45].

The CEO of an IT company said in this regard: "shareholders instruct the directors: this is not correct. That is why director responsibility claims do not generally arise in Armenia."[46] Truly, why hold liable a director for the losses the company suffered, when in reality the shareholders were the initiators of the transaction and the director only signed it in order to adhere to formalities? A reasonable person might consider that the position of a director, CEO becomes useless: why does the Law regulate the institution of executive bodies if their role in the company is only fictitious? Besides, are shareholders qualified enough to manage the business properly, because due management requires particular skills and qualities which most shareholders do not possess?

Another factor all the interviewed were unanimous upon is that in Armenian corporate relations what is called "nepotism" is widely accepted. The founder and the general director of the "ESCo Concern" CJSC said as to this: "The businesses in Armenia are mainly family businesses and that is the reason why corporate business is not developed here". [47] This means that business culture in Armenia differs from what is accepted in the corporate world in general. Indeed, who will sue the executive director of a company if he is a family member of the major shareholder who in its turn initiates and authorizes the major transactions, thus de facto managing the company? This is also a reason why director responsibility issues do not generally arise in Armenia.

In order to find out the perceptions of practicing businessmen whether the outside Director in the hypothetical case presented should be held liable for his actions detrimental to

[45] Bekmezyan, Grigor.
[46] CEO of the IT Company.
[47] Aghabekyan, Sargis.

the company, whether the risk taken by the Director would be considered as a basis releasing him from liability, an inquiry was presented to the both businessmen interviewed.

Mr. S. Aghabekyan told that the director should be held liable for the losses the company has suffered, because business is a phenomenon that is operated by own risk having as its aim gaining profit in a certain period of time. As to him it does not matter whether the director acted in good faith or not: he should be held liable. He elaborated his view further explaining that it is quite normal to include in a director's employment contract such a clause "that he is appointed to gain "x" amount of profit in an "x" amount of time. No profit when the set time has elapsed, a director should be exposed to personal liability". He also stated that high salary of an executive is a rent against personal liability.[48] A prudent person might disagree with the businessmen, because high salary and also business judgment presumptions serve as an incentive for a director to serve in the best interests of a company and its shareholders: never will the high salary be a substitute to personal liability not only for a director of a company but also for any reasonable person. The businessmen's view is a complete rejection of the business judgment presumption and the guarantees this concept offers to a director.

Unlike Mr. S. Aghabekyan, the CEO of an IT company was succinct is his answer to the hypothetical question presented: "The director should not be held liable because he acted in good faith"[49].

The difference of views and perceptions of different businessmen to the same question may prove that not only the Law does not properly regulate corporate responsibility in Armenia, but also the business practice has not formulated common standards which would

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[48] Aghabekyan, Sargis.

[49] On the other hand, both Mr. S. Aghabekyan and the CEO of an IT company agreed that responsibility issues of Armenian executives are decided upon a long-term basis: that the director should be held responsible is not decided based on one short-term transaction which resulted in losses for the company, this is decided based on some recording period.

require businessmen to adhere to those standards, and regulate their business activities not the way they prefer, but the way those standards require.

The CEO of an Armenian Subsidiary of an American IT company explained his views regarding the reasons of improper regulation of corporate responsibility in Armenia. So, in his view these reasons are the transition period of development of the country, emerging of the market, lack of legal consciousness, underdeveloped corporate culture and securities market, lack of professionals. In his view, these are features not only of Armenian but also of some post Soviet Union countries' corporate relations. The CEO concluded that the underdeveloped nature of corporate culture in Armenia regarding corporate responsibility of directors could be overcome if there is a precise and unconditional Law obliging those who are subject to its regulation to adhere to its requirements.[50]

Considering all the connotations of the business practice in Armenia, as well as the character of the Law called to regulate corporate responsibility relations discussed above, a judge of the Court of Appeals of the RA Mr. K. Chilingaryan explained that hardly anyone would sue an erred director, if the damages suffered are not considerable for the company[51]. What is considered to be a "considerable damage" for an Armenian business corporation is not also obvious, because, notably, there is only one case regarding corporate liability of directors in Armenian case law database. Below briefly follows the depiction of the said case:

Shareholders of the "Kecharq" OJSC H. Zohrabyan and A. Navasardyan sued the CEO of the company A. Simonyan and the Chairman of the Board V. Simonyan claiming that they acted not in good faith and in an unreasonable manner, causing the company 28.914.900 AMD in losses. The Board unanimously decided to authorize the CEO of the Company to sell the Company's property (1.01 hectare land in Aghavnadzor, Kotayq Region). The Board determined the market price of the said land as is the requirement of Article 59 of the Law[52]. The basis of the shareholders' claim was that the CEO and the Board Chairman sold the

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[50] Personal Interview. 15 March 2011.

[51] Chilingaryan, Karen. Personal Interview. 24 January 2011.

[52] Article 59 of the Law regulates the procedure of determining the market price of company property.

Company's property at a price below its actual market value: they recalled Article 59, as well as Article 90. The respondents argued that they acted in good faith, fairly determined the market value of the said land pursuant to the requirements of the Law. The former Civil Court of the RA upheld the claim based on Article 59 of the Law holding that the land was sold at a price below its market value, thus granting the claimants 28.914.900 AMD in damages. Appeals to this judgment further reached the Cassation Court which in its turn upheld the judgments of the lower courts holding responsible the CEO and the Chairman of the Board for the losses suffered by the company.[53] What was interesting in this case is that the claimants argued that the Board Chairman and the CEO acted in bad faith and in an unreasonable manner breaching Article 90. Neither of the Courts discussed Article 90's presumptions as to good faith and reasonable manner as bases for the respondents' liability. Instead, all the Courts based their findings mainly on the breach of Article 59, i.e. not properly determining the market value. Neither court, even the Cassation Court which is called to ensure the uniform application of law facilitating the development of the law[54] by interpreting it, interpreted good faith as to what it is, what elements includes and/or when it is considered to be not complied with. The existence of this case may prove that corporate responsibility issues are raised but the legal consciousness of judges, the contradictory wording of the Law and the existing business practice do not allow the Courts to judge corporate responsibility issues under the light of underlying business judgment presumptions, and mainly the concept of "good faith".

[53] Civil Case, HYQD4/0139/02 (2008)

[54] RA Judicial Code, No. HO-135-N, Adopted 21.02.2007, Article 50, Part 1.

Part 3. Overcoming the ambiguities and the contradictory wording of Article 90 of the Law on Joint Stock Companies

It has already been discussed earlier that it is important to regulate the responsibility of corporate directors in a way they have incentives for serving in the best interests of the company, and taking risks for the sake of the business not fearing from liability. It has also been concluded that Article 90 of the Law on Joint Stock Companies which regulates the responsibility of corporate directors does not guarantee those incentives for directors and cannot serve as a proper basis for fair determination of corporate liability. The case outlined above evidences that corporate responsibility issues may arise in the Armenian corporate reality and the due determination of those issues first of all requires the existence of a clear, precise and unconditional law. To this end it is important to incorporate business judgment presumptions into Armenian legal framework. What these presumptions imply is most importantly the due regulation and interpretation of the concept of "good faith" in Article 90 of the Law. Hence, it is suggested to regulate the concept of good faith as a guarantee releasing corporate directors from liability when they comply with a number of provisos, namely:

a) no conflict of interest exists in the outcome of the decision;

b) directors obtain reasonable information on the decision, as well as conduct thorough investigation and estimation and determination of alternatives to their decision;

c) directors follow the established decision-making procedures.

It is also suggested to eliminate the limited scope of the forth part of Article 90 and instead guarantee for directors the conscious taking of business risks even if later on those risks may inflict losses to the company. This provision will encourage a director to serve in the best interests of a company. Moreover, in Armenian reality where mostly directors are at the same time shareholders of a company, they are the most interested in the company's

economic prosperity, and the justification of that prosperity and success should be the freedom to pertain to reasonable business risks without fear of being exposed to liability.

Another suggestion is to change the ambiguous wording of the 2nd part of Article 90 and clearly stipulate that directors are exposed to liability only when losses have been inflicted to the company as a result of intentional (premeditated) action/inaction on the part of a director. This provision will guarantee that negligent or reckless actions/inaction would not be "punished", thus also strengthening directors' ability to resort to business risks. The regulation of these provisions outlined above will also help develop business practices and other factors of importance to the business, because these are just artificial stipulations of the Law not having practical implications, and because there is no yet any common business practice set regarding corporate responsibility in Armenia.

Another alternative suggestion which can contribute to the proper regulation of corporate responsibility of directors in Armenian business reality is encouraging the creation of publicly held corporations, i.e. open joint stock companies. This type of companies may be more democratic in terms of management and responsibility. In publicly held corporations where shares are not concentrated in one or several major shareholders' possession, shareholders would not have much power over the Board and directors, unlike Armenian business reality, thus clearing a path for them to act independently, at the same time necessitating the regulation of appropriate guarantees for them. Besides it may rarely be the case that directors are also shareholders of a publicly held corporation. In these cases business judgment guarantees should be secured for directors to encourage them to act and to serve in the best interests of the company.

All these changes suggested would serve as an incentive for directors to properly discharge their fiduciary duties of care and loyalty owed to the company and at the same time benefit from the rights and freedoms the proper accomplishment of those duties imply. Moreover, the suggestions to making the Law regulating corporate liability clear, unambiguous and precise and broadening the scope of its application securing the inclusion of

business judgment presumptions would serve as a proper basis the judges can resort to when determining corporate liability issues.

Conclusion

This paper has done justice to two different jurisdictions regulating corporate responsibility, stressing its attention towards corporate responsibility implications in Armenia. The US, as a country of Anglo-American legal system, has chosen a judicial presumption to be critical for its model of corporate governance and responsibility. This presumption which has a long and rich history in the US corporate reality is called Business Judgment Rule. The mission of this jurisprudential tool is to shield directors and their decisions from liability in cases when they act in good faith, i.e. when directors do not have conflicting interests, do not engage in illegal behavior, act in the best interests of shareholders, at the same time consciously assuming business risks and adhering to the procedural requirements set by the rich case law.

The goal of the second part of the paper was to reveal whether Armenian Law regulating corporate responsibility leaves room for such an interpretation that business risk is considered as a ground releasing from liability corporate directors who act in good faith, in the best interests of a company even though their actions may cause company to suffer losses. To that end the analysis of Article 90 of the Law on Joint Stock Companies, which regulates the responsibility of company directors, as well as an empirical research bringing to light the views of distinguished law professors, practicing lawyers, successful businessmen and judges regarding connotations of the vague law and not yet developed corporate culture in Armenia, were conducted. It is revealed that provided the article's vague, imprecise and contradictory wording, it is not clear whether good faith and business risk are considered as bases for shielding directors from liability. Hence, this article cannot serve as a proper basis for fair and objective determination of directors' responsibility.

Suggestions were presented intending to overcome the ambiguities of the Law. It is important to incorporate the concept of good faith and its main feature, assumption of business risks, in

regulation of corporate responsibility. The rationale behind this conclusion is that business cannot prosper and develop without conscious business risks assumed. Those risks are the justification of the profit gained. For directors to be eager to resort to business risks for the sake of the corporation, and serve in the best interests of it, it is important to secure guarantees for their protection. These guarantees presume the existence of a clear, unambiguous and precise Law securing the inclusion of business judgment presumptions. The Law of such a quality would serve as a proper basis judges can resort to when determining corporate liability issues.

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