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Certain Issues Related to the Duty of a Company Director to Act Reasonably

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Annotation: This paper examines the legal framework governing the liability of directors in corporate entities, with a particular focus on the balance between managerial accountability and entrepreneurial freedom. It explores the conditions under which a managing director may be held personally liable under Section 43 of the German GmbH Act and comparable provisions in other jurisdictions, notably Russian corporate law. The analysis emphasizes that liability is not intended to shift the inherent business risks of corporate operations onto directors, particularly where such risks are a natural and desirable part of competitive strategy. Drawing on the business judgment rule, the study highlights that directors are protected from liability when decisions are made in good faith, on the basis of adequate information, and with a genuine belief that the decision serves the company's best interests. The research also identifies three essential elements for liability: a breach of duty, the occurrence of damage, and a causal link between the two. Comparative insights illustrate that both German and Russian legal systems recognize the necessity of allowing room for commercially reasonable decisions, even if they ultimately lead to economic failure. This approach aims to prevent excessive judicial intervention in corporate governance and to maintain an environment where directors can act decisively without undue fear of personal financial consequences. The paper concludes that an optimal liability regime must strike a balance between deterring negligent or reckless conduct and preserving the freedom required for effective and innovative corporate management.

Key words: Director's liability, Fiduciary duties, Entrepreneurial risk, Civil liability elements, Judicial review, Damage compensation, Management body, Wrongful conduct, Corporate governance, Causal link.

In corporate law (and civil law in general), any liability is based on an obligation imposed on a specific person. In this context, the discussion concerns obligations within the field of corporate law. If a person is required either to perform a certain act or to refrain from it, but violates such obligations, they may be held liable. A person entrusted with managing the affairs of a corporation must act in a way that maximally safeguards the corporation's interests and behaves reasonably to the extent expected from an average manager. If these normative standards are breached and the corporation suffers harm as a result, such a person may be subject to pecuniary liability before the corporation.

In judicial practice, this reasoning is generally applied as a principle widely used in civil liability literature. Its essence is that, in order to hold a person liable, all elements of liability must be established. In particular, when considering cases on holding a director or another person liable, courts emphasise the necessity of determining the presence of the following three elements: a) Did the defendant (director or other person) breach their obligations? If so, which specific obligation was breached, and through which act or omission? b) What pecuniary loss or other adverse consequence was caused to the corporation? c) Is there a causal link between the breach of law and the corporation's pecuniary loss? If any one of these three conditions is absent, the claim must be dismissed.

In Russian corporate law, a director's liability to the corporation is based on the concept of fiduciary duties. In other words, if a director breaches these duties, they may be held financially liable. This

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concept, originating from Anglo-American law[1], has spread worldwide and is also reflected in Russian corporate law, which recognises two core fiduciary duties:

a) the duty to act reasonably (corresponding to the duty of care principle in English law); and

b) the duty to act in good faith[2].

However, unlike the general civil-law notion of good faith, in the corporate context this duty has a narrower meaning. It is primarily associated with the principle of loyalty or the prohibition of conflicts of interest. This means that a director must not place their personal interests or other interests above those of the corporation (equivalent to the duty of loyalty in English law). The scope of directors' duties and the grounds for holding them liable for their breach are reflected in Plenary Ruling No. 62 (widely applied in corporate law). The ruling is structured in the same way: first, it sets out the duties of a director, and then it specifies the situations in which their breach may occur. However, since the ruling was drafted for practical purposes (namely, to cover the broadest possible range of circumstances in which a breach of duty by a director can be established), it sometimes does not clearly define the precise boundaries of fiduciary duties. For this reason, in the analysis that follows, only cases involving the breach of a single duty will be examined first.

In the latter case, the concept of "acting in good faith" has a broader meaning and is not limited to prohibiting conflicts of interest. It can also draw on the general civil-law principle of good faith, applying both objective standards (e.g., "the director must conduct themselves competently") and subjective standards (e.g., "the director must understand the nature of the transaction they intend to execute"). Such indeterminate situations—where it is difficult to pinpoint exactly which standard the director has breached—are among the most debated issues in judicial practice. Consequently, there is a high likelihood that, in the future, court and arbitral practice will develop divergent interpretations rather than a uniform approach in this area.

The duty to act reasonably represents a comparatively moderate behavioural standard. An analysis of judicial and arbitral practice shows that liability based solely on a breach of this duty is rare. In this regard, Russian law does not differ significantly from other jurisdictions: in most legal systems, holding a director financially liable merely for acting unreasonably is almost unheard of. This means that careless or misguided decisions do not automatically entail liability; it arises only if it can be proven that the director's actions were entirely baseless or demonstrated gross negligence[3].

This situation can be explained from two perspectives.

First, the standard of care expected from a director is actually not that high—it generally corresponds to the behavior of an average director. In other words, a director should understand commercial and business logic, but they are not required to be a specialist or top-level expert in their field. Sometimes this standard is described using concepts like "a good manager" or "a prudent master." Put differently, a director does not need to have the knowledge and experience of a "distinguished figure" in their profession, but they must understand the basic principles of doing business and make reasonable decisions. At the same time, this general standard can vary in certain circumstances. For example, if during legal proceedings the parties can substantiate that a higher or lower standard of care should apply specifically to that director, the standard may be adjusted accordingly.

Second, the director's duty to act reasonably is closely linked to one of the fundamental principles of

[1] Justice Joseph T. Walsh, The Fiduciary Foundation of Corporate Law, 27 J. Corp. L. 333 (2002)

[2] Будылин С.Л. Добросовестность № 4: Беспокойная совесть директора // Закон, ру. 2016. 5 дек. URL: https://zakon.ru/blog/2016/12/05/dobrosovestnost_4_bespokojnaya_ sovestdirektora

[3] Блэк Б., Чеффинс Б., Гелтер М. и др. Правовое регулирование ответственности членов органов управления: анализ мировой практики. М., 2010.

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corporate law—the "business judgment rule.[4]" This rule is designed to protect business decisions from being reviewed retrospectively by courts in terms of their economic soundness.

If courts attempted to evaluate every business decision post factum, they would end up re-examining entrepreneurial risks beyond their intended role. As a result, entrepreneurs might refrain from engaging in business activities out of fear of being held liable for any failure.

Therefore, the business judgment rule also helps to prevent excessive judicial interference in entrepreneurial activities. Courts should resolve legal issues, but they should not be engaged in assessing the commercial merits of entrepreneurs' business decisions. For this reason, it is important to apply a relatively low standard for the reasonableness criterion for directors: a director must be aware of market conditions, but is not required to foresee every possible risk. This approach limits overly active court intervention and preserves the freedom of entrepreneurs to make independent decisions.

At the same time, if the standard of reasonableness for a director's conduct is set too low, and courts—following the logic of the business judgment rule—are not to assess the commercial soundness of a particular business transaction retrospectively, a logical question arises: how can it be determined that the director has breached their duty to act reasonably, and thus be held liable? Or is this duty merely a declaratory statement that in reality does not entail any serious liability?

In fact, when assessing whether a director acted reasonably, courts are forced to perform a dual task: on the one hand, they must avoid excessively scrutinizing the commercial aspects of a transaction so as not to restrict entrepreneurial initiative; on the other hand, they must protect the interests of the corporation and its shareholders. Therefore, courts are compelled to continuously refine the definition of "reasonable conduct by a director" and develop new details related to it.

In addition, the business judgment rule is treated by courts as a conditional protection mechanism (a presumption). That is, a director will not be held liable for their decisions if, in entering into a transaction or assuming risks, they complied with the main procedural requirements. At the same time, if these requirements were violated, the director may be held liable[5].

On this basis, it can be said that the court may draw a conclusion about the economic justification of a particular transaction and may assess, retrospectively, how reasonable it was for the director to enter into such a transaction.

Russian arbitration courts generally adhere to the position that the mere occurrence of adverse consequences during the period when an authorized person is part of a company's management body does not in itself indicate dishonest or unreasonable conduct on the part of the director. Such outcomes are often inherent in the normal entrepreneurial risk associated with business activities. The courts emphasize that their role is not to assess the economic expediency of a director's decisions, but rather to safeguard the rights of the company and its participants. Therefore, if the harm caused by the director's actions falls within the scope of ordinary entrepreneurial risk, the director cannot be held liable for compensating the company. At the same time, the burden of proof lies with the claimant, who must establish the existence of wrongful conduct constituting a breach of fiduciary duties, the occurrence and extent of damage, and a causal connection between these elements.

In corporate law, the liability of directors is carefully balanced to protect both corporate interests and entrepreneurial freedom. The framework recognizes that prudent risk-taking is essential to business success and that not all adverse outcomes stem from managerial fault. By requiring proof of a breach of duty, actual damage, and causation, and by applying the business judgment rule, the law shields directors from liability for commercially reasonable decisions made in good faith and with due care.

[4] Robert Charles Clark, Corporate Law 123-4 (Aspen Law & Business, 1986)
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This approach encourages responsible management while avoiding excessive judicial interference in corporate decision-making.

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4. Robert Charles Clark, Corporate Law 123-4 (Aspen Law & Business, 1986)