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DIRECTOR DUTIES: UZBEKISTAN PERSPECTIVE

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Abstract: This article examines the main duties of directors. The author is concerned with the problematic aspects of the legislation of the Republic of Uzbekistan in which there are ambiguities that in the end cause difficulties in assessing the actions of the directors of companies and bringing them to justice.

Key words: Director duties, Good faith, Reasonableness, The interests of the company, Affiliates, Limited Liability Company, Joint stock company, Company directorship.

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The aim of this paper is to analyse the duties of the directors under Uzbekistan company law. This paper is unique in exploring this issue for the first time in English language. Traditionally, Uzbekistan company law is accessible to those scholars who can command in Russian or Uzbek languages only (which are the dominant languages of the laws and scholarly articles in the country). We hope that our analysis in English here will pave the way for future discussions from overseas scholars and thereby contribute to different points of view and experience sharing with regard to company directorship.

In Uzbekistan, the most common company types (in local legalese - 'organizational and legal forms') are (a) the limited liability companies (LLC) and (b) joint stock companies (JSC), and among the two forms, LLC prevails by quantity. There are several reasons for the popularity of these two forms, in particular, the separate legal personality of the company from its shareholders, the limited liability for shareholders, as well as separation of ownership and control (as

shareholders can delegate the company's management to professional directors). Therefore, our analysis in this paper primarily focuses on director duties in limited liability companies and joint-stock companies.

Before starting the discussion, it would be useful to briefly define the terms commonly used in the discussion. By 'duties of a director" here we mean a set of statutory obligations which a director owes to the company in which the person holds a directorship. We aim at analysing the two key aspects: (i) the existence of director duties and the extent to which they apply, and (ii) the director's liability for failure to comply with the duties. We believe that these two issues are important for efficient functioning of companies which enjoy limited liability by virtue of the law. We believe that it is in the interest of the general public to ensure that the limited liability granted to companies are not misused by persons who run the company (ie directors).

A company can be viewed as a vehicle for capital investment into a specific business activity. In order to ensure the success of the business activities, shareholders appoint professional managers into supervisory boards and executive boards of their companies. In this paper, we refer to those professionals as directors. Shareholders are interested in management of their investments by professionals, who would help to maximize the return on their investments. In return, shareholders are ready to trust their investments into the hands of directors, and expect from them due loyalty and care in managing their assets.

The issue of damages caused to company by their directors was earlier raised by other authors. In particular, in order to improve legislation, one of the Uzbek judges proposed to reveal the content of the principles "good faith" and "reasonableness" referred to in article 42 of the Law on Limited Liability Companies[1]. It must be noted that the principles of "good faith" and "reasonableness" are also provided under Article 45 of the Civil Code of Uzbekistan. It stipulates that a person who by virtue of law or constituent documents of a legal entity acts on its behalf must act in the interests of the legal person he represents in good faith and reasonably. A person is obliged at the request of the founders of the legal entity, since otherwise is not provided by law or by the contract, to compensate losses caused to them by the legal entity.

1 Statutory director duties

As Uzbekistan is a civil law country, one should primarily look for director duties in the legislation passed by the Parliament. Statutory director duties are established by Civil Code, the Law on LLC[2] and the Law on JSC[3].

Article 45 of the Civil Code provides that "A person who, by

virtue of the law or the constituent documents of a legal entity, acts on its behalf must act in the interest of the legal person in good faith and reasonably."

Article 81 of the Law on JSC provides as follows: "Members of the Supervisory Board, the Director and Board members of the company, as well as a trustee shall act in the company's interest and shall bear due liability in exercising their rights and fulfilling their duties."

Article 42 of the Law on LLC envisages that "Members of the Supervisory Board, the company's sole executive body, members of the company's collective executive body shall act in the interests of the company in good faith and reasonably in exercising their rights and fulfilling their duties."

These articles set out three main obligations of directors under Uzbek company law: (a) duty to act in the interest of the company, (b) duty to act in good faith and (c) duty to act reasonably. Below we look at each one by one.

1.1 A duty to act in the interest of the company

We understand the duty to "act in the interest of the company" as requiring directors (a) to consider the interests of the company in all their decisions and (b) to prioritize the company's interests whenever a conflict arises between the interests of the company and other persons.

There is no clear mechanism of how this duty should apply to director activities. However, some of the examples can be found in the corporate legislation.

1.1.1 Transactions with affiliates

A good example is the regulation of transactions with affiliates. The corporate legislation provides for detailed mechanisms for avoiding self-interest transactions or transactions with affiliates - an example where a conflict of interest may exist[4]. Below we look at the mechanism put in place for LLCs and JSCs.

1.1.1.1 Transactions with affiliates in LLCs

Definition of "an affiliate". The following persons are recognized as affiliated persons of the company:[5]

a) Members of the supervisory and executive board;

b) Shareholders holding 20 or more percent of the total number of votes in the company;

c) Spouses, parents, children, siblings and affiliates of the persons in (a) and (b) above. The law does not define what 'affiliates' mean in this statement;

d) A legal entity whose 20 or more percent of shares are owned (individually or jointly) by the persons in (a), (b) or (c) above;

e) A legal entity in whose governance bodies the persons in (a), (b) or (c) above hold an office.

Definition of "a transaction with affiliates". The following transactions are recognized as transactions with affiliates:[6]

a) where an affiliate is a party to the transaction or is representing a third person in the transactions;

b) other transactions prescribed in the company's articles of association.

Based on the above definitions, we can conclude that the Law on LLC uses the following two criteria in regulating transactions with affiliates: (i) control and (ii) representation. Control criterion, in its turn, is based on (a) ownership of at least 20 percent of company votes and (b) governance of the company.

1.1.1.2 Transactions with affiliates in JSC

Definition of "an affiliate". The following persons are recognized as affiliated persons of the company:[7]

a) corporate shareholder (including its trustee and representative) holding 20 percent or more of the shares in the company;

b) individual shareholder (including its trustee and representative) who individually or jointly with close relatives holds 20 percent or more of the shares in the company;

c) members of the supervisory and executive board;

d) a legal entity whose 20 percent or more of shares belongs to the company (including its trustee and representative);

e) a legal entity that is a subsidiary of the company or a subsidiary of the same company, which is a subsidiary of the company;

f) a legal entity, 20 or more percent of shares are owned by a person (including its trustee and representative) who also owns twenty percent or more of shares of the company;

g) a legal entity whose supervisory board's at least one-third of the members is made up of those same persons and their close relatives, who are not less than one third of the Supervisory Board of the company;

h) a legal entity whose executive body is headed by an individual or his close relatives who is a director or member of the board in the company;

i) a legal entity whose head or a member of the executive body holds together with his close relative constitutes not less than one-third of the supervisory board of the company;

j) the legal entity in which a person with his close relatives constitutes at least one-third of the members of the supervisory board and at the same time is a director or a member of board of directors of the company;

k) a legal entity in the same companies association with the company.

The following persons are recognized as affiliates of the individual shareholder who is an affiliated person of the company:

a) a legal person whose 20 or more percent of the authorized capital is owned by the individual shareholder (including its trustee and representative) and (or) his close relatives;

b) a legal entity in which the

individual shareholder or his close relatives are members of the Supervisory Board;

c) a legal entity in which the individual shareholder or his close relatives exercise the powers of the executive body members.

Compared to the definition of and 'affiliate' for LLCs, the scope of coverage for JSCs is much broader. We believe this could be explained by a number of factors, including the fact that JSC's shares can be publicly traded.

Similarly to the approach in LLCs, the Law on JSC uses the "control" criterion in regulating transactions with affiliate, but does not include "representation" as an assessment element. In the same manner, control criterion, in its turn, is based on (a) ownership of at least 20 percent shares and (b) governance.

Definition of "a transaction with affiliates". The transactions with affiliates are defined as a transaction where an affiliate is a party to it.

1.1.1.3 Conclusion on affiliated transactions

We suggest that this regulation of transactions with affiliates can be considered as the director's duty to disclose a conflict of interest. This duty an ex ante mechanism putting in place preventative measures. The duty requires directors to disclose the following information:

a) about companies where affiliates have control (in line with 'control test' suggested here);

b) about current or future transactions which might be recognized as 'transactions with affiliates'.

We believe that the legislator uses share ownership and governance as 'control' tests based on the authority to make decisions or at least influence such decision making in the company. Thus, we could suggest that a person who can make decisions or at least influence such decision making in the company is affiliated with the company and there is a need to put in place measures to prevent conflicts of interest by such affiliated persons. We propose that this need to prevent conflicts of interest is based on the general principle that directors should act 'in the interests of the company'.

1.1.2 To whom the director duties are owed?

At the same time, this duty clarifies to whom the directors owe their duties. The law requires director to act in the interest of the company, and not the interest of the company's shareholders per se. We suggest that directors are obliged to prioritize the interests of the company over the interests of shareholders. Unfortunately, the law does not clarify what would be in the interest of the company.

In order to clarify the essence of the interests of the company, it is recommended to consider the main purpose of the company which is the extraction of profit. It is also necessary to take into account the relevant provisions of the constituent documents and decisions of the

bodies of the company (for example, on determining priority areas of its activities, approving strategies and business plans, etc.). The director cannot be recognized acting in the interests of the company if he acted in the interests of one or more of its shareholders, but to the detriment of the company.

1.2 A duty to act reasonably

The law requires directors to act reasonably, and it is necessary to establish the meaning of 'reasonableness' in this context. Unfortunately, the law does not define what 'reasonableness' mean and we will need to seek for its interpretation from other sources.

In the absence of legal definition, we explore the literal meaning of the word 'reasonable' given in the dictionary of Uzbek language. Literally, 'reasonable' means 'as wise people do', 'with reasoning'[8]. These literal meanings suggest that a director should act as other 'wise people would do' 'with reasoning' in the similar circumstances, we believe this might refer to the need to assess director's actions against what other reasonable director would do. Such assessment, it seems to us, requires calling the skill, knowledge and experience into attention for the purposes of determining director's reasonableness. If our suggestion is correct, then it also means that there should be a minimum set of skill, knowledge and experience which would be required for directors to meet when exercising their powers. It is not clear whether this assessment should be objective (i.e. against an ordinary director) or subjective (i.e. against a director with similar/same skills and experience).

Principle of reasonableness in relation to directors should be understood as a duty of the Director to be sufficiently informed, skilled and experienced before making a decision that will allow the director to act "reasonably", "as wise people would do" in certain circumstances. At the same time, awareness may vary depending on the particular situation and this should be taken into account in the legal assessment of the "reasonableness" of director's action. For example, business decisions can be taken without sufficient information in case of emergency, in the event of delay in collecting information, or where the cost of collecting information may be high for the company. Therefore, some authors suggest to legislate that the failure to obtain the information necessary and sufficient, in the particular circumstances, for a decision-making as a criterion for breach of director's duty to act reasonably.

We caution that the assessment of director's reasonableness should not go into the assessment of directors business judgments. We believe that assessing the contents of director's decisions is overly burdensome and inefficient.

Commentary to the Civil Code suggests that "reasonableness" is the person's awareness of legality of his/

her conduct[9]. Unfortunately, the Commentary does not further elaborate on this interpretation and it is not clear why 'legality' is a decisive criterion for establishing 'reasonableness'.

In the absence of legislative clarification, judicial practice could prove a useful tool in understand the duty to act reasonably. Unfortunately, the number of judicial decisions publicly available is rather limited and we have been unable to further explore.

1.3 Duty to act in good faith

Similar to 'reasonableness', the law does not provide the definition of 'good faith' meaning.

Literally, 'good faith' means 'without deceiving someone", "righteous", "honest" in the dictionary of Uzbek language[10]. These literal meanings suggest that a director should act righteously, honestly and without deceiving others, i.e. refers to director's behaviour. Based on the moral nature of the term, the definition of "good faith" is very difficult.

On the other hand, some authors suggest establishing criteria for misconduct[11]. In their view, such a list must be open and leave the possibility for judicial discretion. We also support this approach, which would take into account the particularities of each situation and increase the flexibility of enforcement to the legitimate needs of business.

Having considered the experience of different countries (United Kingdom, United States, South Korea, etc.), some authors identified the following main breaches of the duty to act in good faith:[12]

- entering into a transaction with a direct or indirect conflict of interest without proper disclosure or approval;
- intentionally or knowingly (knowing) corporate violation (for example, the convening of the annual or extraordinary general meeting, denying the approval of the annual report of the company) or other legislation (e.g., violation of antitrust law or environmental law in the manufacturing), including cases in which such violation is aimed at obtaining a benefit for the company;
- intentional acts or omissions with the knowledge that they are against to the interests of the company;
- intentionally or knowingly gross dereliction of duty to society (e.g., repeated absences from the meetings of the Supervisory Board or of the Board without reasonable excuse; repeated refusal to accept decisions on issues that should address the Supervisory Board or the Management Board; intentional or deliberate breach of duties under the corporate laws, including the breach of the duty to act reasonably and in the public interest; breach of the duty of disclosure of information on transactions with interest);
- profit from use of business (commercial) capabilities, which

also could be profitably used by the company. Responsibility should occur in cases where there are reasonable grounds for believing that society itself was interested in this opportunity. However, no liability should be incurred when the commercial opportunity was disclosed to the company and members of the Supervisory Board, have no conflict of interest, gave consent to the use of specified features.

In the absence of legislative clarification, judicial practice could prove a useful tool in understand the duty to act in good faith. Unfortunately, the number of judicial decisions publicly available is rather limited and we have been unable to further explore.

2 Liability for breach of director duties

We suggest that failure to comply with at least one of the above three duties should be sufficient to justify recognition of director's action as unlawful and guilty[13]. Here we explore the liability of directors for breach of their duties. We believe that remedies should be efficient enough to restore the wrong done to the company (as directors owe their duties to the company).

We propose to group the remedies available to the followings:

a) Corporate remedies. This group includes the remedies available under corporate law. For example, the laws on LLC and JSC empower general meeting of shareholders to early terminate the authorities of a director. This is an efficient remedy for shareholders to

b) Contractual remedies. Under Uzbek law, directors are also generally regarded as employees and therefore every director has an employment agreement concluded with the company. These employment agreements may also, to a limited extent, provide for contractual remedies to the company in case breach of the director duties.

c) Civil remedies. This group includes the remedies available under Civil code and other civil legislation of Uzbekistan.

d) Public law remedies. This group includes the remedies available under administrative and criminal laws. We suggest that these remedies should be minimum enough to protect the interests of the general public. For example, directors may be disqualified for up two five years if they commit a criminal offence of hiding company's bankruptcy.[14]

We intend to analyse each group of remedies in forthcoming research articles.

3 Conclusion

Corporate laws of Uzbekistan establishes three main duties of a director of a company, namely, (i) a duty to act in the interests of the company, (ii) a duty to act in good faith and (iii) a duty to act reasonably.

The first duty requires director to prioritize the interests of the company over their personal,

shareholders, and of third persons. This duty also requires directors to avoid conflicts of interest. We suggest this duty has more legal certainty.

The other two duties are based on the princi ples of "good faith" and "reasonableness" and lack clear definitions. Literal interpretation suggest that "good faith" requires honesty in director's behaviour. "Reasonableness", by literal meaning, requires directors to act "based on reason", "as other wise people would do" and expects a director to have a minimum set of skill, knowledge and experience.

The authors here propose a need for legislative or judicial initiative for clarification for assessment of good faith and reasonableness expected from directors. Such clarification would increase the legal certainty of corporate legislation, allowing potential investors and owners to crystallize what the law allows them to expect from their directors, who will be managing for them their property invested into the company. For directors this clarification will also give legal certainty in terms of their liability for business decisions that they make.

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