By Peter Swiecicki

An up-and-coming employee of a Michigan-based company with international operations gets her dream assignment: move abroad to become head of her firm's recently-opened operations in a developing country. Her assignment proceeds well, until a year later, when the general counsel in the home office receives an urgent e-mail from the employee, saying that she has been invited to an interview at the prosecutor's office to discuss a transaction with the parent company that she oversaw. Following a quick consultation, local counsel in the foreign country advises that the manager's conduct in the transaction is potentially criminal.

Managing a Foreign

Managers[1] of foreign subsidiaries of U.S.-based companies are faced with an extensive array of potential criminal and personal liabilities. The above scenario is a potential adverse outcome if the company's corporate compliance program is inadequate to manage these risks. Recent attention in corporate compliance matters has focused on the Sarbanes-Oxley Act, and its reporting requirements and potential criminal liability for managers. However, this law only applies to publicly-traded companies. Nearly all international operations of U.S. companies involve closely-held affiliates that are incorporated in foreign jurisdictions, to which non-U.S. regulations on public trading of securities do not apply.

In almost all legal systems, managers have a duty of care to their company, and a breach of such duty results in personal liability to the company. Short of pursuing legal claims for such breaches, a parent company/shareholder can ordinarily ensure compliance with the duty of due care through direct rights to appoint and dismiss managers; performance review and career advancement mechanisms; and compensation arrangements. All of these are more desirable and effective for a company than a public, after-the-fact lawsuit seeking damages from a discredited manager.

But risks also arise from outside the company, first through potential criminal liability for acts that would not necessarily be considered criminal in the United States, and second for personal liability to third parties due to tort liability, insolvency, breach of fiduciary duty, and non-payment of taxes.

The parent company needs to be concerned about such risks of criminal and personal liability because, in addition to the obvious risk of direct costs and the loss of the ability of a skilled manager to perform her duties, the parent company also risks the potential loss of its investment and its loss of reputation.

Potential Criminal Liability

Although Michigan law is not a hotbed of statutes providing for potential criminal liability for corporate managers, numerous other states have turned a wide variety of misconduct into criminal activity. Such crimes include fraudulent misappropriation or conversion of corporate property, failure to make an annual certificate of the company's affairs, unlawfully declaring a dividend, or intentional fraud in failing to comply substantially with the articles of incorporation. Also, federal criminal liability can be found in laws such as RICO or the antitrust laws.[2]

Therefore, it should come as no surprise that managers in foreign countries may be faced with similar risks. In France, for instance, it is a crime for a manager to distribute fictitious dividends, to knowingly publish inaccurate accounts, to use company assets in bad faith contrary to the interests of the company, or to use the company's powers in bad faith to assist another company in which the manager has an interest.[3]

The law of agency has a long-standing principle of general applicability: in most countries an agent (read: manager) who commits an act constituting a crime is personally accountable, notwithstanding that such agent was acting in an official or representative capacity for the principal (read: company).[4]

The further one looks, the broader the concept of managerial crime may become. An Israeli manager is subject to criminal liability if she "knowingly acts regarding the operation of the company or its

There are many risks of criminal and personal liability

assets, in a way which harms the ability of the company to abide by its obligations, or if [she] knowingly does something which harms the proper functioning of the company. These definitions have great latitude and may refer, for example, to a director who commits the company to obligations which [she] knows it cannot fufil, etc."[5]

In Poland, the potential liability is just as broad or even broader. A manager who acts to the detriment of her company or causes it a substantial loss is subject to up to five years of imprisonment.[6] Crucially, no defense such as the business judgment rule or reliance upon a shareholders' authorizing resolution exists.

Thus, one may hypothecate the following case: a U.S. company decides to sell a division that operates in three foreign countries, including Poland. A buyer and price is agreed. Because the division does not operate independently in the foreign countries, an asset sale is agreed. Under the allocation of the purchase price, the assets in Poland are to be sold at less than book value. Even though the global sale has been vetted by investment bankers, who have confirmed the global purchase price; the U.S. board of directors have approved the sale; and no issues arise under the business judgment rule from a global perspective, the manager in Poland is faced with the dilemma of whether and how to sign the agreement, given the nature of the proposed transaction in that country and its potential consequences.

Personal Liability to Third Parties

Tort Liability

As a general rule, managers owe a duty to their company for the fulfillment of their duties, and such duty does not extend to third parties. In Japan, however, managers may be directly liable to creditors if they have been guilty of wrongful intent or of gross negligence in the assumption of their duties.[7]

This general rule is further modified if a third party has been injured by a manager's specific tort. As a general policy principle, it may be deemed unnecessary to grant third parties the right to state claims for a manager's failure of her duty to a company, provided that the company is solvent and thus able to meet the claims of such third parties. However, if the manager commits a tort directly injuring specific third parties, personal liability of such manager may be deemed justified.[8] Such torts may include, for example, negligent representations or personal injuries. It can be seen that further analysis could soon expand this issue into a global survey of tort law.

Insolvency

I noted above the distinction that third parties should not have claims on managers, provided that the company is solvent. Under a great many laws, insolvency changes the analysis and may result in the personal liability of managers. In England, if a manager knew before a company's insolvency liquidation that such liquidation was unavoidable, and the manager did not take steps to mitigate the potential damages of creditors, the director might be personally liable for contributing to the extent of such damages.[9] In France, such liability will accrue if a manager mismanages the company, and such mismanagement leads to the insolvency.[10]

In Germany, creditors whose claims are not satisfied by a company may assert their claims against the managers directly, upon showing that such managers have grossly violated the duty of care of diligent and conscientious managers. No liquidation or winding-up proceeding is required.[11]

In several countries, the manager becomes personally liable if she fails to cause the company to file for bankruptcy on a timely basis.[12]

These insolvency issues are faced by any manager of a start-up company, which ordinarily incurs losses in its initial years of operations. Such losses impair stated capital, and the company's continued availability of funds to pay creditors in the short-term is wholly reliant upon parent company loans or guarantees. The manager in such cases is wholly reliant on the parent company not just for the subsidiary's financial health, but her own.

Breach of Fiduciary Duty

Managers generally have a duty of loyalty and a duty of care to their company. These duties extend principally to the company as, for instance, in the personal liability of managers of limited liability companies to repay distributions made in violation of operating agreements.[13] An example of the duty of loyalty can be seen in the manager's duty not to engage in a separate business that competes with her company.

The business judgment rule is generally available to U.S. managers to protect against liability for breach of fiduciary duty. But such rule does not protect managers who cause losses due to their failure to act in circumstances in which due attention would arguably have prevented the loss.[14]

In foreign countries, with no business judgment rule or otherwise having legal systems with different rules, a crucial issue in assessing such duties is whether the manager may seek approval or ratification of proposed or prior actions, respectively, through shareholders' or directors' resolutions. If so, this may absolve the manager of potential liability,[15] but in other instances no such absolution may be available. Even though these fiduciary duties generally run to the company and not to third parties, in some cases they may be asserted by third parties, as is the case in Japan cited above.

Unpaid Taxes

In contrast to the haphazard approach of states to potential criminal liability of

Fast Facts:

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company managers, personal liability of managers for unpaid taxes is much better defined. In Michigan, for example, the basic principle is that if companies generate revenue through taxable transactions, the managers are personally responsible for non-payment of such taxes.[16]

Many foreign countries apply the same principle, or extend it to potential criminal liability of the manager.[17] In this context, the greatest risk may follow a scenario along these lines: a manager may believe that she has paid all required taxes, but a tax audit results in a substantial assessment against the company. Under local procedural rules, an appeal can only be filed if the company first pays the tax. Moreover, if the company fails to pay the assessment in a timely manner, the tax officials may seize the company manager's assets (most likely by freezing bank accounts), in recognition of the manager's personal liability. When the manager arranges a meeting to discuss a settlement, it turns out that the tax officials have no authority to negotiate settlements, only to assess and collect taxes.

The result is heightened manager anxiety, loss of sleep, loss of valuable management resources dealing with these issues, and a fairly effective strong-arm method for tax collectors.

Indemnification and Insurance

Having reviewed these risks, it could be argued that indemnification and insurance can be used to resolve any problems that arise. Although indemnification and insurance programs are undoubtedly prudent, indemnification may not be available in cases where the manager was aware of the potential unlawfulness under foreign law of an act;[18] under the same circumstances, insurance may also not cover potential liabilities.

Second, even though we assumed at the beginning that the foreign subsidiary was not publicly traded, the U.S. parent company might be, and this raises the issue of whether public disclosure is required of any criminal allegations, with attendant unfavorable publicity. Even if the matter does not become publicized outside the U.S. company, internal control procedures should be in place to assure reporting of alleged criminal activity to the company's officers and directors. Such internal publicity is normally not the kind that foreign country heads and inside legal departments are seeking.

Conclusion

Fraud and breach of trust are the common themes of the types of criminal and personal liability discussed above. The federal legal system in the United States means that U.S. companies are used to dealing with a complex web of legal risks when assessing the potential criminal and personal liabilities of the managers of their domestic operations. Despite variations, however, the federal system has achieved great uniformity when compared with the legal complexities of international operations.

Even if the concepts of fraud and breach of trust are recognized as the risks to watch out for, the cited examples show that applications of those concepts to specific fact situations in legal systems throughout the world are too varied for any compliance program to ensure total risk prevention. Careful compliance programs will recognize that systems vary, will have appropriate mechanisms to signal and flag unusual liabilities, will convey such information to managers, and will ensure contact with local counsel to provide the needed advice.

This article began with a cautionary tale. Despite this, please be assured that the vast majority of managers of foreign companies have successful careers without facing the situation of our hypothetical manager. Manage with your eyes open, but don't be deterred. Professor Lon Fuller reminds us that Thomas Aquinas long ago wrote that if a ship's captain were instructed that his paramount duty was to avoid all risk to his ship, he would never put to sea.[19] ✦

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Footnotes

1. As used in the U.S., "managers" has a broad context and includes more than just a company's directors and officers. In many foreign countries, "manager" has a narrower meaning, restricted to members of the company's management board, who must be identified in the company's public register. In many jurisdictions, the liabilities discussed may also apply to members of a company's supervisory board. Referring to members of management boards and supervisory boards is analogous to referring to officers and directors of U.S. corporations. For purposes of this article, "manager" refers to this narrower context of management board members or the equivalent, and potentially supervisory board members.
2. See 3A *Fletcher Cyc. Corp* Section 1358 (perm. ed. 2002), citing numerous state statutes, but none from Michigan.
3. Christopher Joseph Mesnooh, *Law and Business in France: A Guide to French Commercial and Corporate Law* 47 (1994).
4. Kathleen F. Brickley, 1 *Corporate Criminal Liability* Section 5.01 (2d ed. 1992).
5. Alon Kaplan, ed., *Israeli Business Law: An Essential Guide* 188 (1999).
6. Commercial Companies Code of 15 September 2000 Section 585.1 (Polish Journal of Laws no. 94, item 1037); Criminal Code of 6 June 1997 Section 296.1 (Polish Journal of Laws no. 128, item 840).
7. Zipora Cohen, "Directors' Negligence Liability to Creditors: A Comparative and Critical View," 26 *J. Corp. L.* 351, 354 (2001).
8. Id. at 376. See Douglas C. Michael, "To Know a Veil," 26 *J. Corp. L.* 41, 47 (2000).
9. Id. at 384.
10. See Mesnooh, supra n. 3 at 156.
11. Cohen, supra n. 8 at 388. See also Enno W. Ercklentz, Jr., 1 *Modern German Corporation Law* 163–164 (1979).
12. For Austria, see Kurt Heller, Heinz Löber, George Bahn, Werner Huber, Gunther Horvath, *Austrian Business Law: Legal, Accounting and Tax Aspects of Business in Austria* 159 (1984). In Poland, such failure is a crime, Polish Commercial Companies Code, supra n. 6, Section 586, which also subjects the manager to personal liability to the company, id. Section 483.
13. MCL 450.4308.
14. Cindy A. Schipani, "Taking it Personally: Shareholder Liability for Corporate Environmental Hazards," 27 *J. Corp. L.* 29, 44–45 (2001).
15. E.g., Heller et al., supra n. 12, at 159.
16. See, e.g., MCL 141.664a(2) (city income tax); 205.27a(5) (SBT); 205.65 (sales tax); 205.96(5) (use tax).
17. For example, Austria, see Heller et al., supra n. 12, at 508–510.
18. See MCL 450.1561. Analogously, MCL 450.1209 provides that personal liability of managers can be limited, except as to intentional criminal acts.
19. L. Fuller, *The Morality of Law* 185 (2d ed. 1969).