Liability of Directors on mismanagement and bankruptcy

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Generally, directors of a joint stock company ("KSC") have a broad authority to manage the company, provided that such powers of management are not restricted by the provisions of the articles of association and/or resolutions of the shareholders of the KSC. However, directors of a KSC may be subject to civil and criminal liabilities for mismanagement and bankruptcy of the KSC pursuant to the provisions of the Law No. 15 of the Year 1960 Regarding the Commercial Companies Law ("CCL").

Civil Liability as a Result of Mismanagement
Under the CCL, directors of a KSC can be held personally liable for criminal acts as a result of their negligence. This does not extend to all directors but only the director who committed the negligent act or omission. As a result, directors of a KSC can be subject to claims for mismanagement by shareholders and/or third parties.

Article 148 of the CCL states the following:

"The Chairman and members of the board are liable to the company, to shareholders and to third parties for all acts of cheating (fraud), abuse of authority as well as for any violation of the law or of the Articles of Association and for fault in management. Resolutions of the General Meeting discharging the directors of liabilities shall not bar the initiating of proceedings for liability."

In light of the above provision of the law, directors of a KSC may be personally liable for any of four types of acts/omission:

1. Fraud; or

2. Abuse of authority; or

3. Contravention of the law or the Articles of Association of the KSC; or

4. Fault in management.

Standard of Care: To establish liability, it is necessary to define the boundary of the standard of care required or expected of directors of a KSC.Given the lack of court precedents in this area, it is arguable that the required standard of care for directors is the "Prudent Person" standard with an average experience and competencies, varying from one industry to another. The "Prudent Person" is the reasonable person who exerts and applies the same standard of care when running his or her own affairs. This subsequently means maximum effort and care in managing the KSC's affairs taking into account the KSC's best interests.

Abuse of Authority: The CCL does not provide for the meaning of "abuse of authority". Neither does any other related law for that matter, such as the Kuwait Law of Commerce. In the commercial sense and using the "Prudent Person" test, "abuse of authority" may be best measured when a prudent director acts contrary to or omits to act in the best interest of the KSC.

Fault in Management: There is no definition of what constitutes “fault in management” under the CCL. Therefore, it is possible to give a wide interpretation as to cover any sort of mismanagement. Further, Article 146 of the CCL provides directors with the right (subject to the law, the articles of association and resolutions of the shareholders’ general meeting) to carry out all necessary matters which are consistent with the objects upon which the KSC was established. This establishes that the authority of directors to carry out all necessary things to achieve the objects of the KSC. Therefore, the objects of the KSC are the standard by which the acts would be judged to have authorized or ultra-vires acts of the directors, and not the KSC. However, it is not practical to hold directors liable for every fault in management because the effect would be that no one will want to assume or accept to be nominated as a director of a KSC. Therefore, it is necessary to distinguish between three kinds of liability: (a) director’s liability – serious fault; (b) director’s responsibility – minor fault; and (c) pure corporate liability.

Civil Liability as a result of bankruptcy
Article 684 of the CCLholds members of the board responsible for the KSC’s debts, presuming that the KSC filed for bankruptcy (with the potential of proving that reasons include mismanagement of its affairs). Article 684 states that:
“Where after a company is declared bankrupt, it is revealed that its assets are insufficient to discharge at least 20% of its debts, the Court may, pursuant to an application by the bankruptcy receiver, order the mangers, directors or any of them to pay jointly or otherwise all or part of the debts of the company, unless they prove that in administering the company’s affairs, they have exercised due care.”

However, there are conditions that must be met in order to arrive to that point. They are as follows:

1. The KSC must be declared bankrupt or insolvent;

2. Insufficiency to pay the KSC’s debts of 20% of its debts. (therefore, 80% of KSC’s assets would have been entirely wiped out. But if there remain 20% of its assets sufficient to pay 20% of its debts, directors and managers may not be liable);

3. The trustee in bankruptcy would request the Court to declare the bankruptcy of the directors;

4. Members of the board fail to disprove mismanagement or misuse of the KSC’s resources or other faults as per Article 148 of the CCL (therefore, the onus of proof shifts to the managers and directors to disprove that they did nothing that contravenes Article 148)

5. There must be a judgment by the Courts obligating members of the board to pay the debts of the KSC where the Court finds that they committed either of the acts in Article 148 and the Court may declare a judgment against one of them whether severally or jointly as in addition to opposing such other conditions as it sees fit.

Criminal Liability in the context of bankruptcy
The CCLimposes a number of criminal sanctions and make them subject to imprisonment for actions taken prior to bankruptcy and also for action taken after bankruptcy.

Articles 789 of the CCL and onwards provide that if a bankruptcy judgment is issued, directors can be subject to imprisonment for up to 5 years if it is proven that they undertook any of the following after the date of suspension of payment of debts:

1. Hide the KSC’s records and books;

2. Embezzle or hide any of the KSC’s assets;

3. Intentionally declare invalid debts regardless whether such declaration is made in writing or verbally, in the financials of the KSC, by refraining from submitting documents or clarifications;

4. Undergo judicial settlement through fraud;

5. Declare untrue capital;

6. Distribute untrue profit or received bonuses in excess of the limits imposed in the Articles of Association of the KSCor set forth in the law;

7. Dispose assets and funds of the KSC with the intention to deprive creditors from rights to such funds or assets;

8. Make payment to a creditor in a manner that defeat other creditors;

9. Grant any security to a creditor to defeat other creditors;

10. Dispose the KSC’s assets at less than its “normal” price to delay the suspension of payment status, or to delay bankruptcy or revocation of judicial settlement;

11. Use illegal ways to obtain funds to delay the suspension of payment status, or to delay bankruptcy or revocation of judicial settlement;

12. Spend gross funds in gambling or speculations not required in the ordinary course of business of the KSC; or

13. Participate in matters violate the law, the Articles of Association of the KSC or ratify such actions.

In cases listed in 8 and 9 above, sanctions apply even if such actions were made in an attempt to conclude a judicial settlement.

In general, directors have a fiduciary duty to the KSC and its shareholders. Directors are required to exhibit good judgment and exercise such care and diligence in running the KSC as a reasonably prudent man would do in comparable circumstances. The law grants shareholders of the KSC and/or third parties the right to claim damages against directors for acts or errors in managing the KSC, whether or not committed in bad faith and thereby exposing directors to potential liability for any of the KSC’s misfortunes.