

DIRECTORS' LIABILITY IN THE TWILIGHT ZONE

PREADVIEZEN / REPORTS 2017



NVRII

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In November 2016, the European Commission presented its proposal for a Directive on Preventive Restructuring Frameworks, Second Chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures. The draft Directive provides for the possibility to reorganize prior to and outside of court supervised insolvency procedures. It envisions that such preventive restructurings should enable enterprises to restructure at an early stage and to avoid the opening of formal insolvency procedures.

In general, the entire draft Directive provides a very facilitating approach to all parties involved and one could have expected a similar approach to the directors. It could have taken away many of the possible concerns as to liability in granting securities to obtain interim finance or concerns when simply continuing trading. However, any such comfort for the directors is lacking in the draft Directive, leaving the discussion regarding director liability wide open.

In four reports, leading practitioners and academics from Germany (Rolf Leithaus and Christian Lange), Belgium (Stan Brijs and Arie Van Hoe), England (Peter Declercq) and the Netherlands (Loes Lennarts), reflect on the current role and responsibilities of directors in the twilight zone in their respective jurisdiction and what role liability should play also under the envisioned Directive. Recurring issues are possible directors' liability for incurring new liabilities, selective payment, duty to file for insolvency and liability for deepening the insolvency. These reports were presented and discussed at the annual meeting of NACIIL on 9 November 2017 in Amsterdam.

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LOES LENNARTS, STAN BRIJS, ARIE VAN HOE, ROLF LEITHAUS,
CHRISTIAN LANGE AND PETER J.M. DECLERCQ

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The Netherlands

Tel.: +31 70 33 070 33

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NACIIL-REPORTS 2017: DIRECTORS' LIABILITY IN THE TWILIGHT ZONE

The legislative efforts of the European Union with respect to insolvency were, for a long time, limited to providing uniform rules of international private law on the competent court, applicable law and recognition by means of the European Insolvency Regulation. In recent years, the legislative efforts have shifted towards harmonisation of substantive insolvency law at a European level. The most defining characteristic of this harmonisation attempt is the focus on reorganisation instead of liquidation.

In November 2016, the European Commission presented its proposal for a Directive on Preventive Restructuring Frameworks, Second Chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures. The Directive provides for the possibility to reorganise prior to and outside of court supervised insolvency procedures. The Directive envisions that such preventive restructurings should enable enterprises to restructure at an early stage and to avoid the opening of formal insolvency procedures. By the term 'restructuring', we mean the legal terminology, namely the re-ordering of the capital structure. The draft Explanatory Memorandum to the proposed Directive states the following as to the benefits of restructuring over liquidation (p. 13): "*A successful restructuring plan will turn non-performing loans into loans a company can actually pay back. In liquidation, secured creditors have to consider the possibility of substantial reduction in the value of their claims. In restructuring, on the other hand, insolvency is avoided, contract debts are in general paid, and negotiations concern in most cases only the financial debt.*"

The draft Directive seeks to stimulate reorganisation. To that effect, the draft Directive of course contains many rules enabling the debtor to restructure its debts by offering a reorganisation plan which can be made binding on parties including dissenting creditors and shareholders. The Directive provides for a *preventive* restructuring framework allowing the company to restructure *outside* a court supervised procedure, whilst keeping the debtor in possession (article 5 Directive). The draft Directive thereby requires that national laws provide for a debtor-in-possession model. Furthermore, the draft Directive provides that Member States shall ensure that new financing and interim financing are adequately encouraged and protected (article 16 and 17 Directive).

By introducing the debtor-in-possession model, the question as to the duties and possible liabilities of directors gains even more significance. It is the director of the debtor who has

the leading role in the reorganisation and it is the director that appears to carry risk. In general, the entire draft Directive provides a very facilitating approach to all parties involved and one could have expected a similar approach to the directors, since they are the ones that walk the tightrope. For instance, the draft Directive could have taken away many of the possible concerns as to liability in granting securities to obtain interim finance or concerns when simply continuing trading. However, any such comfort for the directors is lacking in the draft Directive, leaving the discussion regarding director liability wide open.

The provisions in the draft Directive only lists the duties of the directors. Article 18 of the draft Directive, for instance, provides that Member States shall lay down rules to ensure that, where there is a likelihood of insolvency, directors shall have the following obligations: (a) to take immediate steps to minimise the loss for creditors, employees, shareholders and other stakeholders; (b) to have due regard to the interests of creditors and other stakeholders; (c) to take reasonable steps to avoid insolvency; (d) to avoid deliberate or grossly negligent conduct that threatens the viability of the business. Little to no emphasis is placed on the rights and protection the directors may count on. It would seem that under the draft Directive, the responsibility is placed with the directors rather than with the contractual counterparties and other stakeholders.

In four reports, leading practitioners or academics from Germany (Rolf Leithaus and Christian Lange), Belgium (Stan Brijs and Arie Van Hoe), England (Peter Declercq) and the Netherlands (Loes Lennarts), reflect on the current role and responsibilities of directors in the twilight zone in their respective jurisdiction and what role liability should play also under the envisioned Directive. Recurring issues are possible directors' liability for incurring new liabilities, selective payment, duty to file for insolvency and liability for deepening the insolvency. These reports were presented and discussed at the annual meeting of NACIIL on 9 November 2017 in Amsterdam.

In bringing these reports together and also in the English language, NACIIL hopes to contribute to the development of a fair, efficient and effective European Insolvency Law. NACIIL wishes to express its thanks to all the authors for writing these highly interesting reports.

May 2018
Board of NACIIL

PREVENTIVE RESTRUCTURING AND DIRECTORS' DUTIES AND LIABILITIES IN THE TWILIGHT ZONE: THE DUTCH PERSPECTIVE

NVR II REPORT

Loes Lennarts*

1 INTRODUCTION

The aim of this report is to assess what consequences, if any, the implementation of Article 18 of the draft EU Directive on Preventive Restructuring Frameworks¹ will have for directors' duties and liabilities 'in the vicinity of' insolvency under Dutch law. In order to be able to make this assessment, an overview will be given of the duties and liabilities of directors in the vicinity of insolvency under Dutch law. This overview is not exhaustive; it focuses on the case that the board of the company is making an honest attempt to rescue the *company* by means of a court-sanctioned scheme as proposed in the draft EU Directive. Currently, distressed businesses in the Netherlands are most often restructured by means of a (pre-packaged) bankruptcy sale by the liquidator of (parts of) the *business*, followed by liquidation of the insolvent company. Considering that this is not the form of restructuring envisaged in the draft Directive, the position of directors who continue to trade while preparing a (pre-packaged) sale of (part of) the business will not, as such, be discussed in this report.² Because the focus of this report is on directors making an honest attempt to rescue the company, the recently introduced provisions on disqualification of directors will not be addressed.³ Provisions of criminal law relating to bankruptcy fraud will only briefly be touched upon (in Section 4).

* University of Groningen.

1 Proposal of 22 November 2016 (2016/0359 (COD)) for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30 EU.

2 For the liability risks that directors (and the silent liquidator appointed by the court) may run during the preparation of a pre-pack, see (in Dutch): F.M.J. Verstijlen, 'To Pre-Pack or Not to Pre-Pack', in *Wet Continuïteit ondernemingen (delen I en II) en het bestuursverbod*, preadviezen Vereniging Handelsrecht, Zutphen: Paris, 2014, pp. 61-65.

3 On 1 July 2016, the Bill on directors' disqualification entered into force, incorporated in sections 106a-e of the Dutch Bankruptcy Act (DBA). At the request of the liquidator or the public prosecutor, the (district) court may disqualify a director in case (inter alia) he committed bankruptcy fraud or if directors' liability on the basis of Section 2:248 DCC has been irrevocably established. A director may be disqualified under civil

In order to give the non-Dutch reader some understanding of the context of the topic discussed in this report, a few preliminary issues will be dealt with in the following sections. Section 2 aims to equip the reader with a general understanding of board structures and directors' duties in the Netherlands. Section 3 contains a general outline of the most important statutory provisions that may serve as a foundation for liability claims against corporate directors in the event that the company has become insolvent. Section 4 contains a summary of the transaction avoidance provisions in the Dutch Bankruptcy Act (DBA) and corresponding provisions of criminal law. In Section 5, a brief description is given of the draft Bill for a court-sanctioned scheme of arrangement that has recently been published for consultation. Section 6 describes the most important liability risks under Dutch law for directors who have kept the company afloat, while attempting to achieve a rescue of the company by means of a court-sanctioned scheme of arrangement. Section 7 contains the answers to specific questions the reporters were asked to answer. Section 8 concludes this report with an assessment of how the implementation of Article 18 of the proposed Directive would affect Dutch law and practice.

2 SETTING THE SCENE

2.1 *Board Structures in the Netherlands*⁴

Book 2 of the Dutch Civil Code (DCC) regulates two types of stock companies with limited liability, the besloten vennootschap (BV) and the naamloze vennootschap (NV). All NVs and BVs have a board of directors ('bestuur'). A statutory basis for the one-tier board structure was introduced in 2013, but this structure is still very much the exception in the Netherlands.⁵ The dual board structure, distinguishing between the board of directors and the supervisory board ('raad van commissarissen'), is far more common. Supervision of (executive) directors by supervisory board members (two-tier board) or non-executive directors (one-tier board⁶) is mandatory for companies that meet certain requirements (so-called 'structuurvennootschap-

law for a maximum period of 5 years, during which he may not act as a director or supervisory director of a legal person (company).

4 For a detailed description of board structures and directors' duties and liabilities in the Netherlands, see Richard R.J. Nowak, 'Corporate Boards in The Netherlands', in Paul Davies *et al.* (Eds.), *Corporate Boards in Law and Practice*, Oxford: OUP, 2013, pp. 446 ff. and 493 ff.

5 In March 2017 only 58 out of a total of 3998 NVs and 385 out of a total of 896.613 BVs had opted for the one-tier board structure (Instituut voor Ondernemingsrecht and the Institute for Governance and Organizational Responsibility of the University of Groningen, *Evaluatie Wet bestuur en toezicht*, WODC: 2730/798987, available at: wodc.nl.)

6 In the Dutch one-tier board structure, the non-executive directors have, at least, the task of supervising the executive directors.

pen').⁷ Only natural persons can be appointed as supervisory board members or non-executive directors. (Executive) directors can be legal persons. The use of legal persons acting as directors is quite common in the Netherlands, especially in groups of companies. To ensure that natural persons cannot use a legal person to escape liability, Article 2:11 DCC provides for a form of statutory 'veil piercing'. Any director liability incurred by a legal person acting as a director rests jointly and severally on those who are its directors.⁸ The aim of this provision is to achieve that, ultimately, liability incurred by legal persons acting as directors rests on natural persons.

In a dual board structure, members of the management board and members of the supervisory board have the distinct tasks of managing the company respectively supervising management. Supervisory board members are not responsible for any management errors made by the board. They can only be held liable for a failure to properly supervise the management board. All members of a board of directors, in both the one-tier and the two-tier system, always bear joint responsibility for the 'general course of business', no matter how the tasks have been divided among them.⁹ This means that even if the non-executive directors in a one-tier board have been exclusively charged with the task to supervise management, they still bear collective responsibility for the 'general course of business'. This phrase is generally understood to include strategic and financial policy, matters relating to risk control and acquisitions that are of great importance for the identity of the company.¹⁰ Collective board responsibility is a fundamental principle underpinning the liability provisions of director liability in Book 2 DCC, which will be discussed in Section 3.

In the following sections of this report, for brevity's sake, no attention will be paid to the duties and liabilities of supervisory board members. The discussion will be limited to (executive) directors. It should be noted, though, that Dutch practice has shown that it will be expected of supervisory board members to be deeply involved in the company's affairs when it is facing a financial crisis. In the case of *KPN Qwest*, the Enterprise Chamber of the Amsterdam Court of Appeal, in enquiry proceedings, blamed the members of the supervisory board for stepping down on the day that the company filed for suspension of payments. According to the Enterprise Chamber, under the (*dire, LL*) circumstances the company found itself in, the supervisory board should not have accepted, without a fight, that the company was at the mercy of the bank. The supervisory board should have independently investigated alternative scenarios.¹¹

⁷ See Art. 2:153/263 and 2:158/268 DCC.

⁸ For a detailed discussion of how this provision works, see M.L. Lennarts, "Piercing the corporate director" – Over de (on)zin van art. 2:11 en art. 106a lid 2 Fw', in G. van Solinge *et al.* (Eds), *Aansprakelijkheid van bestuurders en commissarissen*, Serie vanwege het Van der Heijden Instituut, Deel 140, Deventer: Wolters Kluwer, 2017, pp. 157-199.

⁹ See Art. 2:9 (2) DCC.

¹⁰ A.P. Schild and L. Timmerman, *WPNR* 2014/7011.

¹¹ Amsterdam Court of Appeal (Enterprise Chamber) 28 December 2006, *JOR* 2007/67 (*KPN Qwest*).

2.2 *Enquiry Proceedings: Stepping Stone to Liability Proceedings or Settlements*

The Enterprise Chamber of the Amsterdam Court of Appeal can order an enquiry into the affairs of the company if there are serious reasons to call the policy of the company into question.¹² In the enquiry proceedings, the court does not assess whether or not (supervisory) board members can be held liable for mismanaging the company (or failure to adequately supervise management) or for misleading investors. However, if the Enterprise Chamber concludes, on the basis of the report prepared by the investigators appointed by the Enterprise Chamber, that the policy of the company was improper ('wanbeleid'¹³), this can be a stepping stone to liability proceedings,¹⁴ in particular in the event that the Enterprise Chamber has also identified the persons responsible for the improper management.¹⁵ In the event that a listed company has gone bankrupt, a class action may be brought against the listed entity (and its directors) by disgruntled investors, who may claim to have been misled about the company's financial situation by the company (and its directors and officers). Such a claim could, for example, be based on the fact that the company has not (timely) disclosed its solvency issues or issued misleading statements concerning its solvency.¹⁶ The facts established in the enquiry proceedings can also serve as a basis for the liquidator to sue the directors of the company for mismanagement.¹⁷ Cases in which liability proceedings are actually instituted after enquiry proceedings are rare.¹⁸ It should be noted, however, that a declaratory judgment that the policy of the company was improper is a strong incentive for directors to reach a settlement with those

12 Art. 2:350 (1) DCC.

13 Art. 2:355 DCC. Failure to correctly inform investors can qualify as 'wanbeleid', see Amsterdam Court of Appeal (Enterprise Chamber), 5 April 2012, *JOR* 2013/41 (*Fortis*).

14 See G. van Solinge, 'Van wanbeleid naar aansprakelijkheid', in G. van Solinge *et al.* (Eds.), *Aansprakelijkheid van bestuurders en commissarissen*, Serie vanwege het Van der Heijden Instituut, Deel 140, Deventer: Wolters Kluwer, 2017, p. 514.

15 With the (sole) purpose of ordering them to pay (part of) the costs of the enquiry, see Art. 2:354 DCC.

16 Amsterdam Court of Appeal (Enterprise Chamber), 5 April 2012, *JOR* 2013/41 (*Fortis*), District Court Utrecht 15 February 2012, *JOR* 2012/243 (*Fortis*). In the latter case the liability claim was brought on the basis of the findings in the investigators' report, even before the Enterprise Chamber had rendered its declaratory judgment.

17 A famous case in which enquiry proceedings in respect of a bankrupt listed company were followed by a claim brought on behalf of investors as well as a claim brought by the liquidator (which claims resulted in a settlement) is the *Landis* case. See Amsterdam Court of Appeal (Enterprise Chamber) 15 December 2011, *JOR* 2012/77; District Court Central-Netherlands 19 June 2013, *JOR* 2013/237 and District Court Amsterdam 28 October 2015, *JOR* 2015/330. A more recent case is the bankruptcy of *Imtech*. In this case the Dutch Association of Securities Holders (VEB) and the liquidators have joined forces to find out what led to Imtech's collapse and to, eventually, institute liability proceedings to any persons who they believe to be responsible with the aim of reaching a settlement. See (in Dutch): <https://www.veb.net/acties-menu/actie-overzichtspagina/actie-imtech-faillissement/algemeen>.

18 See S.J. van Calker, 'Wanbeleid, kostenverhaal en aansprakelijkheid, een fact check', in G. van Solinge *et al.* (Eds.), *Aansprakelijkheid van bestuurders en commissarissen*, Serie vanwege het Van der Heijden Instituut, Deel 140, Deventer: Wolters Kluwer, 2017, pp. 535-539.

claiming compensation, in particular if they were held responsible for this policy by the Enterprise Chamber.¹⁹

2.3 *The Duty to Manage the Company 'in the Corporate Interest'*

Members of a board of directors have the duty to manage the company '*in the interest of the company and the enterprise related to it*'.²⁰ The highlighted phrase reflects that Dutch company law is stakeholder-oriented. Directors do not owe their duties exclusively to the company's shareholders. To some extent, they also have to take the interests of other stakeholders (notably employees and creditors) into account. It is common opinion in Dutch legal doctrine and case law that the corporate interest of a subsidiary company is 'colored' by the group interest, but that it cannot be identified with the group interest.²¹ In this context reference can be made to the judgment of the Dutch Supreme Court in the *Juno*²² case. A claim based on manifest mismanagement had been brought by the collector of taxes against the directors of a subsidiary company who had, under pressure from the parent company and the bank, cooperated with the splitting up of the group in viable companies to be saved and non-viable companies (including the subsidiary in question) to be allowed to fail (in Dutch such a restructuring operation is known as a 'sterfhuisconstructie'). The Court of Appeal held that there had been no mismanagement because the board of a group like Juno will do anything to meet the bank's demands and to separate the viable parts of the business as much as possible from the non-viable parts, in order to save as many viable parts of the business as possible. The Dutch Supreme Court corrected this part of the Court of Appeal's judgment by holding that the Court of Appeal had obviously only taken the group interest into account and in doing so neglected that mismanagement must be established separately for each of the companies belonging to the group. In this process "the group interest can play a role, but it cannot be decisive in the sense that it prevails over the other interests involved in the various group companies." The latter should be interpreted as meaning that the group interest does not prevail *a priori*. In a situation such as the one at hand in the Juno case, the board of the subsidiary needs to balance the different interests at stake.²³ The Court of Appeal took a short cut by holding that there was no mismanagement without reviewing whether the subsidiary's board had indeed balanced the interests.

19 Van Solinge, *Id.*, p. 515.

20 See art. 2:129 (5) and 2:239 (5) DCC.

21 Asser-Maeijer-Van Solinge & Nieuwe Weme, II-2*, *De rechtspersoon*, Deventer: Kluwer, nr. 829.

22 HR 26 oktober 2001, NJ 2002, 94.

23 The unenviable position of directors of subsidiary companies who are instructed by the controlling shareholder to do something that may benefit other group companies but harm the subsidiary's own interests is a topic that certainly merits attention in the context of restructuring attempts. It is not discussed here because it falls outside the scope of this report. The same applies to the duties and liabilities of controlling shareholders in this context.

There is no express rule in Dutch company law that, once a company becomes insolvent or near-insolvent, the directors must give priority to the interests of the creditors over those of the shareholders (and other stakeholders) of the company. However, this principle is reflected in, for example, the statutory provision that directors of a private limited company may not approve distributions to shareholders when they (should) foresee that the company will not be able to pay its debts as they fall due (see Section 3.1.3). Moreover, as will be illustrated in Section 5, it is well-settled (tort) law that directors may be held to owe a duty of care toward the joint creditors and, in certain circumstances also individual creditors, when there is a foreseeable risk of the company becoming insolvent. In Dutch doctrine, the shift in directors' duties that occurs when the company is (near) insolvent is widely acknowledged.²⁴

3 DIRECTORS' LIABILITIES IN THE EVENT OF A COMPANY'S INSOLVENCY UNDER DUTCH LAW

3.1 *Directors' Liability in Book 2 of the Dutch Civil Code (DCC): Joint and Several*

The principle in Book 2 DCC that all members of the management board are collectively responsible for proper management of the company translates, in principle, into joint and several liability of all board members in the event of a successful claim based on either of the two provisions discussed below. Individual board members may try to exculpate themselves. Claims do not necessarily have to be brought against all directors. A director who has paid more than his share of the compensation may try to take recourse against co-directors in separate proceedings.

3.1.1 **Liability of Directors toward the Company for Mismanagement (Art. 2:9 DCC)**

In case of mismanagement of the company, (de jure) directors can be held jointly and severally liable on the basis of Article 2:9 DCC for the damage they have caused to the company by their mismanagement. The claim based on Article 2:9 DCC belongs to the company. In the event that bankruptcy proceedings have been opened in respect of the company, the claim will be brought by the liquidator, on behalf of the company. The liquidator needs to show that there has been improper management ('*onbehoorlijk bestuur*'), which can only be attributed to a director when the standard of 'serious reproach' is met ('*ernstig verwijt*'). The requirement of 'serious reproach' is meant to ensure that directors are not held liable for

²⁴ See, e.g., Van Bekkum in his comment on DSC 23 May 2014, JOR 2014/229 (Kok/Maas q.q.): "The more insolvency looms, the more a director must fulfil his duties in the interests of the creditors of the company."

every mistake they make in managing the company. The following rationale for this requirement was given by the Dutch Supreme Court in its judgment in the case *Willemsen/NOM*:

The acceptance of a high threshold for the liability of a director towards the company also serves the interest of the company and the enterprise related to it by preventing that directors allow their behaviour to be defined to an undesirable degree by defensive reasons.²⁵

Whether or not a 'serious reproach' can be made depends on the facts and circumstances of the case. In the landmark decision in *Staleman/Van de Ven*, the Dutch Supreme Court mentioned the following circumstances that may be relevant: the nature of the company's activities and the risks inherent in these activities, the way in which tasks have been assigned among the directors, any relevant guidelines to which the directors should adhere, the information available to the directors and the understanding and care expected of directors who are fit for their task and fulfill it diligently.²⁶ The last element means that directors are held to an objective standard of care and skill.

When it has been established that there has been improper management, the liquidator needs to establish causation between the improper management and the loss he claims to have been suffered by the company. Individual directors may try to exculpate themselves by showing that they cannot be 'seriously blamed'. It has been pointed out earlier that all directors bear responsibility for the general course of business, in spite of the facts that specific tasks may have been assigned to individual directors. Moreover, a director can only exculpate himself if he shows that he has not been negligent in taking measures to avoid the consequences of improper management. This means that in practice it will be very difficult for directors to exculpate themselves.

Because Article 2:9 DCC is of a mandatory nature, the company cannot *ex ante* waive the right to bring a claim based on this provision against directors. The general meeting can grant directors a discharge *ex post*. Such a discharge offers a limited amount of protection; it only covers facts that have been disclosed in the annual accounts or at the general meeting.²⁷ Moreover, a resolution granting a discharge can, pursuant to Article 2:15(1)(b) DCC, be annulled if the discharge is contrary to reasonableness and fairness. Several authors submit that the liquidator can also use the *actio pauliana* to challenge a discharge if the general meeting voted in favor of relinquishing the claim, knowing that the company's creditors would be prejudiced as a result.²⁸

25 DSC 20 June 2008, NJ 2009, 21 (*Willemsen/NOM*).

26 DSC 10 January 1997, NJ 1997, 360 (*Staleman/Van de Ven*).

27 DSC 10 January 1997, NJ 1997, 360 (*Staleman/Van de Ven*).

28 See, e.g., J. Barneveld, Dividend, decharge & disculpatie, WPNR 2011/6893 en I.C.P. Groenland, Uitkeren aan aandeelhouders (hoe) kunnen we dat doen, *O&F* 2012/4, H.e. Boschma en J.N. Schutte-Veenstra, De BV uit de steigers!, *Ondernemingsrecht* 2012/116.

3.1.2 Liability of BV Directors toward the Company for Making Unlawful Distributions to Shareholders

According to Article 2:216(2) DCC,²⁹ directors of a BV have the explicit task of approving distributions to shareholders. The extent of this task is that they must submit the proposed distribution to a solvency test. Directors may not approve a distribution when *they know or should have known that, after the distribution, the BV will not be able to continue to pay its debts as they fall due*. If they violate this provision, they can be made jointly and severally liable by the company for the deficit, to the extent that it has been caused by the distribution. This means that the compensation that must be paid is limited to the loss suffered by the company's creditors. In practice, the claim based on Article 2:216(3) DCC is brought by the liquidator, after the company has entered insolvent liquidation proceedings.³⁰ It is noted that Article 2:216(3) DCC does not cover so-called 'hidden' distributions and that both formal and hidden distributions may be subject to avoidance by means of the *actio pauliana*.³¹

As a consequence of the fact that the legislator has characterized the approval of an unlawful distribution as improper performance of duties owed to the *company*, the mechanism of discharge also plays a role here. Theoretically, the general meeting can relinquish the claim of the company against a director who has allowed a distribution of dividends that harms the interests of the company's creditors. In practice, such a discharge will be subject to invalidation on the grounds of reasonableness and fairness or avoidance on the grounds that the creditors were defrauded by the discharge (*actio pauliana*).³²

29 This provision was introduced in 2012 in the context of a complete makeover of the Dutch law on private limited companies (BVs).

30 A similar claim can be brought against BV directors who have repurchased shares when they know or should have known that, after the repurchase, the BV will not be able to continue to pay its debts as they fall due (*see* Art. 2:207 (3) DCC).

31 In the *Kelderman* case the DSC basically upheld the appellate court's decision that formal distributions to shareholders may be challenged on the basis of Art. 42 and 45 of the DBA (*actio pauliana*). *See* DSC 23 September 2016, NJ 2016, 498 (*Hage q.q./Kelderman*). It is noted that Art. 2:216 (3) DCC also provides that distributions can be recovered from any shareholder who knew or should have foreseen, at the time the distribution was made, that, after the distribution, the company would not be able to continue to pay its due and payable debts. So the liquidator can choose against whom he brings his claim. If he targets the shareholders, it is easier to bring an avoidance claim, because it is submitted that the distribution qualifies as a legal act not against value received (as decided by the appellate court in the *Kelderman* case), which has two important consequences. First, legal acts not against value received do not require any knowledge on the side of the receiving party, here the shareholder. So whereas Art. 2:216(3) DCC does require such knowledge on the side of the shareholder, the general provision on transaction avoidance does not require such knowledge on the side of the shareholder. Second, legal acts not against value received do still require on the basis of Art. 42 DBA, the knowledge of prejudice on the side of the debtor, here the company paying dividend. There is, however, a statutory provision in Art. 45 DBA, which presumes such knowledge existed if the legal act not against value received was conducted within 1 year prior to the opening of the insolvency procedure. Therefore, if the liquidator wants to target the dividend payment to shareholders, it is much easier to do so on the basis of transaction avoidance than on the basis of the specific provision of Art. 2:216(3) DCC.

32 *See* footnote 31.

3.1.3 Liability of Directors of an NV/BV toward the Estate for Mismanagement Causing the Company's Bankruptcy (Art. 2:138/248 DCC)

In the event that the company is subject to bankruptcy proceedings, the liquidator can also bring a mismanagement claim based on Article 2:138 (NV)/248(BV) DCC, provided that certain requirements are met. This claim was introduced in the 1980s as part of a series of laws targeting abuse of legal persons. This is reflected in the fact that the claim can be brought against *de facto* directors as well as *de jure* directors. There is no distinction in the Netherlands between *de facto* and *shadow* directors. All (legal) persons who have "defined the policy of the company as if they were a director" qualify as a *de facto* director for the purpose of Article 2:138/248 DCC.

For a claim on the basis of Article 2:138/248 DCC to succeed, the first step is that the liquidator must establish that there has been manifestly improper management ('*kenmerkend onbehoorlijk bestuur*') within a time frame of 3 years prior to the opening of the bankruptcy proceedings. Management qualifies as manifestly improper "if no reasonably thinking director would have acted in such a way."³³ The prevailing opinion seems to be that directors can only be held liable for manifestly improper management *if they should have foreseen that the way in which it fulfilled its task (or neglected to do so) would harm the creditors' interests*.³⁴ The second step is that the liquidator must show that the manifestly improper management is an important cause of the bankruptcy. The burden of proof for the liquidator is alleviated considerably if the annual accounts have been published too late³⁵ or the bookkeeping duties³⁶ have been neglected. If the liquidator succeeds in showing that one (or both) of these duties have been neglected, manifestly improper management is established and it is presumed that this is an important cause of the bankruptcy, unless the violation of the duties mentioned is 'insignificant'. In practice, liquidators often invoke the statutory presumptions, especially in the event that the annual accounts have not been published in time. Directors may still escape by proving that another circumstance that cannot be attributed to improper management is an important cause of the bankruptcy.³⁷ If the directors' defense does not succeed, they are jointly and severally liable for the full deficit. Individual directors may try to exculpate themselves but this is difficult as has already been pointed out in respect of the claim based on Article

33 DSC 8 June 2001, NJ 2001, 54 (*Panmo*).

34 Van Schilfgaarde/Winter/Wezeman/Schoonbrood, *Van de NV en de BV*, Deventer: Kluwer, 2017, p. 208.

35 To avoid the presumptions of Art. 2:138/248 DCC, the accounts should be published within 12 months from the end of the financial year for any financial year that commenced after 1 January 2016 and 13 months for financial years that commenced before this date. An insignificant delay is ignored. Whether a delay qualifies as insignificant also depends on the reason given for the delay. The longer the delay, the harder it will be to give an acceptable explanation for it.

36 The duty to keep proper accounts is codified in Art. 2:10 DCC. It is a core duty for directors. Without proper accounts, the board is flying blind with missing instruments, which is obviously risky but even more so when the pilot is weathering a storm.

37 DSC 30 November 2007, NJ 2008, 91 (*Blue Tomato*).

2:9 DCC. As a last resort, directors can ask the court to mitigate the amount of compensation to be paid to the estate. Article 2:138/248(4) DCC provides for a limited amount of circumstances that may lead to mitigation. The only circumstance that may give rise to individual mitigation is the (limited) period of time an individual director was in office when the improper management occurred. The compensation can be mitigated for all directors collectively, having regard to the nature and the seriousness of the improper management, the other causes of the bankruptcy and the way in which the liquidator has administered the estate.

3.2 *Liability of Directors Based on the Tort of Negligence*

The tort of negligence is regulated in Article 162 of Book 6 of the DCC. This article contains the general provisions concerning tortious liability. Pursuant to Article 6:162 (2) DCC, torts can be divided into three categories: the violation of a right, an act of omission violating a statutory duty, or an act of omission violating a non-statutory duty of care. It is the latter category on which a vast body of case law has been built. In every specific case, the court defines the duty of care that should have been observed according to ‘unwritten’ law, having regard to the facts and circumstances of the case.

For a successful negligence claim against a director of a company, the plaintiff, in the context of this report: the liquidator or an individual creditor, needs to show that the directors violated a duty of care owed to joint creditors, respectively to the individual creditor bringing the claim. Furthermore, in the event that the tort was committed by the defendant in his capacity as director of a company,³⁸ the plaintiff needs to show that the standard of ‘serious reproach’ is met. The principle of collective responsibility does not apply in case of a tort claim against a director. This means that, if the plaintiff brings a claim against multiple directors, he needs to prove separately for each one of them that a duty of care owed to the plaintiff has been violated and that the standard of ‘serious reproach’ is met. Similarly to what has been discussed in respect of Article 2:9 DCC, the court will have regard to all facts and circumstances of the case in order to establish whether a ‘serious reproach’ can be made.

In the landmark case *Ontvanger/Roelofsen*,³⁹ the Dutch Supreme Court made a distinction between two main categories of cases in which directors can be made personally liable for debts owed by the company. The Court held that if one or more creditors suffer loss because the company does not pay and offers no recourse for the debt(s) it owes, there may, depending on the circumstances of the specific case, be grounds for liability,

38 If the person who is (also) a company director commits a tort that bears no relationship with his directorship, for example because in his capacity as real estate agent he is sued for professional negligence, the standard of serious reproach does not apply, see: DSC 23 November 2012, *NJ* 2013, 302 (*Spaanse Villa*).

39 DSC 8 December 2006, *NJ* 2006, 659.

aside from the liability of the company, of the person who as a director (1) *acted on behalf of the company* or (2) *has caused or allowed the company to breach its contractual or statutory obligations*. In both cases personal liability of the director toward the creditor (s) of the company can only be established if the director, in view of his duty to properly fulfill his task as meant in Article 2:9 DCC, meets the standard of 'serious reproach'. In the case that the director *played a role in incurring new debts on behalf of the company* (category 1) the standard of 'serious reproach' will be met when the director, at the time when the debts were incurred, *knew or reasonably should have known that the company would not be able to meet its debts and would not offer recourse*. In the event that the director *caused or allowed the company to breach existing contractual (or statutory) obligations* (category 2), the director will only be personally liable if, having regard to the circumstances of the case, the director's acts of negligence constitute a breach of the duty of care, which is grave enough to satisfy the standard of 'serious reproach'.

In the relevant cases following its judgment in *Ontvanger/Roelofsen*, the Supreme Court gave little guidance as to when exactly the standard of 'serious reproach' will be met in the wide variety of cases falling within category 2. For the purpose of this report, it suffices to say that knowledge of the director that the 'victim' of the breach of contract (or statute) will not be able to have recourse against the company (in other words: *knowledge that the company is or will soon become insolvent*) may bring the court to rule that the standard of 'serious reproach' has been met. However, other circumstances may also be taken into account. One thing is clear from the case law: the mere fact that the company is unable to compensate creditors in the event of a breach of contract or statute in which a director played a role is not enough to make a director personally liable on the grounds of negligence.

3.2.1 Violation of a Duty of Care Owed toward the Joint Creditors

In the event that the loss caused by the tortious behavior of one or more directors has been suffered by the creditors collectively, the liquidator has the right to bring a claim against director(s).⁴⁰ The Dutch Supreme Court has ruled that this is not an exclusive right, but that, in the event of a competing claim by one or more individual creditors, the court may decide to hear the liquidator's claim first.⁴¹ If the liquidator brings such a claim, the proceeds will be paid into the estate and distributed in accordance with the rules on ranking of creditors.

Cases in which the liquidator may hold a director personally liable for violation of a duty of care owed to the joint creditors are when the director has:

- knowingly allowed the company to engage in a transaction at an undervalue (unlawful withdrawal of assets);

⁴⁰ DSC 14 January 1983, NJ 1983, 597 (*Peeters/Gatzen*).

⁴¹ DSC 21 December 2011, NJ 2005, 95 (*Lunderstädt/De Kok*).

- knowingly allowed the company to engage in a transaction that constitutes an unlawful preference ('selective payments').

The specific circumstances in which a claim against a director for making selective payments will be successful will be discussed in Section 6.2.

3.2.2 Violation of a Duty of Care Owed toward Individual Creditors

The liquidator does not have standing to bring a negligence claim against one or more directors if the duty that has allegedly been violated is owed to one or more specific creditors. Such claims must be brought by the individual creditors themselves. The most common⁴² example of such a claim in practice is the case labeled as category 1 in Section 3.2: a creditor claims compensation for the loss suffered due to the fact that the director did not disclose to the creditor that the company would not be able to perform the obligations arising from the contract concluded by the director on behalf of the company. This type of claim goes by the name *Beklamel*-claim, after the landmark case of the Dutch Supreme Court.⁴³ A *Beklamel*-claim cannot be brought by the liquidator, even if he brings several of these claims on behalf of a group of creditors who all claim to have been misled by the director.⁴⁴

4 TRANSACTION AVOIDANCE AND CORRESPONDING PROVISIONS ON BANKRUPTCY FRAUD IN THE CRIMINAL CODE

Rescuing a company in distress usually involves securing fresh credit, which will only flow to the company if it offers some form of security to the lender that the money will be repaid. In the event that the rescue attempt fails and the company becomes insolvent, the secured lender will take recourse against the assets that were pledged or mortgaged to secure the loan. This means that the proceeds of a sale of these assets will, to the extent that they are used to satisfy the secured lender's claim, not be available to the other unpaid creditors. Then the question arises as to what extent the provision of security for fresh credit can be challenged by the liquidator with the *actio pauliana*.

Another issue that merits discussion in this section is to what extent a company that finds itself in the 'zone of insolvency' can lawfully honor due and payable debts to existing creditors, when it may be clear that not all creditors will receive full payment. Some creditors will be vital for the success of the restructuring attempt. Therefore, it is common practice for companies in 'the zone of insolvency' to prefer certain creditors that are

42 It falls outside the scope of this report to discuss all possible negligence claims that individual creditors may bring against company directors.

43 DSC 6 October 1989, NJ 10990, 286 (*Beklamel*).

44 DSC 16 September 2005, NJ 2005, 311 (*De Bont/Bannenberq q.q.*).

demanding payment of due debts over others. The question is to what extent preferential payment of due and payable debts can be challenged under Dutch law.

Both questions are discussed in this report on directors' liability because company directors will necessarily be involved in the provision of security to a lender and in any preferential payments made in the 'zone of insolvency'. If a director is involved in a transaction that is characterized as unlawful (and therefore voidable) by the Dutch Bankruptcy Act, this raises the question of whether he can be made personally liable for his involvement in this transaction, offering the liquidator an alternative course of action if for some reason he does not wish to challenge the transaction itself. This will be further discussed in Sections 7 of this report.

The provisions in the Dutch Bankruptcy Act on avoidance of transactions regulate the avoidance of 'legal acts' ('rechtshandelingen'). The Act distinguishes between legal acts that were performed because the debtor was under a legal obligation to do so (obligatory acts) and acts that were performed voluntarily. If a debtor receives fresh credit and offers security to the bank for this credit, both transactions qualify as voluntary legal acts. Pursuant to Article 42 DBA a voluntary legal act can be challenged if it was prejudicial to the creditors and if both the debtor and the counterparty knew or should have known that the transaction would be prejudicial to the other creditors. In case of a failed restructuring attempt, the granting of a security right for emergency credit will be prejudicial to the remaining creditors because, after the transaction, the remaining creditors are faced with a secured creditor who will take recourse against assets that would otherwise also have been available for the satisfaction of their claims.⁴⁵ This leaves the element of 'knowledge of prejudice to the creditors'. According to the Dutch Supreme Court, the test is whether

at the time of performance of the act the opening of the insolvency proceedings and a deficit were foreseeable with a reasonable amount of probability for both the debtor and its counterparty.

This test also applies when the transaction under attack is part of an attempt to avert insolvency by a rescue plan.⁴⁶ The rather opaque criterion introduced by the Dutch Su-

45 DSC 8 July 2005, NJ 2005, 457 (*Van Dooren q.q./ABN Amro II*). The fact that the new money was used to pay some of the company's debts does not alter the fact that the creditors are prejudiced in the event that those claims ranked as common unsecured claims. In the old situation, all common unsecured creditors would share in the proceeds of the assets. In the new situation, the claims of those common creditors that were paid are replaced by the lender's secured and therefore preferential claim. This means that the proceeds of the assets that were provided as security will be used to pay the debt owed to the lender and will not be shared with the other creditors.

46 This was recently confirmed in DSC 7 April 2017, JOR 2017/213 (*Jongepier q.q./Drieakker*). In this case, involving an attempt to rescue a group of companies, the DSC held that the Court of Appeal had applied the wrong criterion by holding that the counterparty to the transaction under attack had no reason to believe that insolvent liquidation was inevitable and that it could not be said that the rescue attempt was destined to fail.

preme Court has sparked a lively debate.⁴⁷ It is not clear what exactly is meant by ‘a reasonable amount of probability’. It leaves a considerable degree of uncertainty for the lender, who, according to the Supreme Court,⁴⁸ will have to thoroughly analyze (and document, *LL*) the viability of the restructuring plan before the secured credit is granted.

The preferential payment of a debt that is due and payable cannot be challenged pursuant to Article 42 DBA. Such a payment qualifies as an obligatory legal act that can only be avoided in two circumstances: (1) when the debt was paid, the counterparty *knew that the bankruptcy petition had already been filed*; or (2) *collusion between the debtor and the counterparty to favor the counterparty over the other creditors*. According to case law, both circumstances are to be construed narrowly. It is not sufficient that the counterparty knows that a bankruptcy petition is imminent.⁴⁹ Nor does the fact that the counterparty has exerted pressure on the debtor to pay qualify as collusion. The element of collusion requires that the debtor intended to prefer the counterparty.⁵⁰

The Dutch Criminal Code contains several provisions on bankruptcy fraud. Some of these provisions provide a legal basis for criminal prosecution of directors who have been involved in transactions in the ‘zone of insolvency’ that have prejudiced the company’s creditors. *De jure* and *de facto* directors can, inter alia,⁵¹ be prosecuted for withdrawing assets from the estate or unlawfully preferring any creditor of the company prior to the opening of the bankruptcy proceedings, if they do so *knowing that one or more creditors of the company will be prejudiced*.⁵² For a criminal conviction, it suffices that the director has willfully accepted the considerable chance that one or more creditors would be prejudiced (*dolus eventualis*).⁵³ Prosecution on the grounds mentioned is only possible in the event that bankruptcy proceedings have actually been opened in respect of the company. If found guilty, the accused directors can be sentenced to a prison term of up to 6 years or a penalty of up to € 82,000.

5 COMPANY/BUSINESS RESCUE IN THE NETHERLANDS, NOW AND IN THE FUTURE

As has already been noted in the introduction, the predominant way of business rescue in the Netherlands is the (pre-packaged) asset sale after the company has been declared

47 For a brief discussion of the case and the debate in English, see R.J. de Weijts, E.J.R. Verwey, C. Bärenz and R.M.A. Connell, Financing in distress against security from an English, German and Dutch perspective, *ILLR* 2012.

48 DSC 22 December 2009, *NJ* 2010, 273 (*ABN Amro/Van Dooren III*).

49 DSC 29 June 2001, *NJ* 2001, 662 (*Meijs q.q./Bank of Tokyo*).

50 DSC 24 March 1995, *NJ* 1995, 628 (*Gispen q.q./IFN*).

51 Because this report focuses on directors involved in (bona fide) restructuring attempts and not on bankruptcy fraudsters, only those provisions are mentioned that may have some relevance (albeit remotely) in the context of a restructuring attempt.

52 Art. 343 Dutch Criminal Code.

53 Verheul, *Tekst & Commentaar Strafrecht*, art. 343, comment nr. 8 under a.

bankrupt. In addition to restructuring through bankruptcy, the debtor could attempt to try and achieve a composition with creditors after filing a petition for suspension of payments ('surseance van betalen'). A company can request suspension of payments if it foresees that it will not be able to pay all its creditors when claims become due and payable.⁵⁴ If the petition is granted, the common unsecured creditors cannot enforce their claims against the debtor.⁵⁵ Because the rights of preferential creditors (including holders of mortgages and charges) are not stayed and because any composition sanctioned by the court during suspension of payments does not bind the preferential and secured creditors, in practice, few companies are rescued by way of suspension of payments. In fact, these proceedings most often are just a prelude to bankruptcy proceedings. It is very difficult to achieve a scheme of arrangement outside insolvency proceedings, because the main principle is that creditors can insist on receiving full payment. Only in exceptional cases will the court rule that a creditor who is holding out abuses his right to do so or acts contrary to reasonableness and fairness.⁵⁶

To improve the chances of a company being restructured outside insolvency proceedings, the Dutch government wishes to introduce a procedure by means of which non-consenting creditors can be bound to a restructuring plan. A draft Bill on court confirmation of extrajudicial restructuring plans (*Wet Homologatie Onderhands Akkoord* (WHOA)) was published for consultation on 5 September 2017.⁵⁷ The essence of the draft Bill is that a restructuring plan proposed by the debtor and voted on (in classes) by creditors and shareholders can, if certain requirements are met, request the court to cram down the plan against one or more dissenting classes of creditors and shareholders. A debtor company can only offer a plan if it anticipates that it will not be able to continue paying its due and payable debts. This means that the debtor company making use of this procedure will find itself somewhere on the sliding scale to insolvency, which raises the question of how the debtor can attract fresh secured credit in view of the transaction avoidance risk that the lender runs (see Section 4).

To tackle this issue, the WHOA proposes to introduce what is meant to be a safe harbor provision for secured interim financing in a new article of the DBA (Art. 42a DBA).⁵⁸

Where the debtor, prior to the opening of bankruptcy proceedings, has created a charge or mortgage to secure the payment of debts arising from a loan that

54 Art. 214 DBA.

55 Art. 232 DBA.

56 DSC 12 August 2005, *NJ* 2006, 230 (Groenemeijer/DC&C Payroll Services).

57 The draft Bill and the draft Explanatory Memorandum are available (in Dutch) at <https://www.internetconsultatie.nl/wethomologatie>. For an unofficial English translation see www.resor.nl/eventbanner/RESOR_Amendment_to_the_Bankruptcy_Act.pdf and <https://www.debrauw.com/publication/draft-bill-continuity-companies-act-ii-wcoii/>.

58 See Art. 16 of the proposal for an EU Directive on Preventive Restructuring Frameworks.

was granted to the debtor with the aim of enabling the debtor to make payments reasonably necessary for the continued operation of the debtor's business during an effort to implement a restructuring plan as meant in Art. 370, in the absence of proof to the contrary, it is presumed that there was no prejudice to creditors and knowledge of such prejudice as meant in Art. 42.

This text is somewhat puzzling, because in its current wording this provision still allows the liquidator to prove that (1) the secured interim financing was prejudicial and (2) both parties to the transaction were aware of this. This is no different under current law. The Explanatory Memorandum offers some insight into what the drafters of the proposed act actually intended. According to the explanation, the proposed Article 42a only allows the liquidator appointed in the bankruptcy proceedings following a failed restructuring attempt to challenge the legal act, if he shows that (1) *the loan was not used to make payments necessary for the continued operation of the business in view of the achievement of a composition, thus leading to prejudice for the creditors*, and (2) the grantor of the loan knew or should have known *this* and could foresee that a bankruptcy and a deficit would be the result of this.

The Explanatory Memorandum clarifies that the liquidator needs to show that the money was not used to make payments necessary for the continued operation of the business in view of the achievement of a composition. This is not the same as proving that there was no prejudice, because in the event that the rescue attempt fails, there may very well be prejudice, even if the money was used to make payments necessary for the continued operation of the business. This follows from the case law of the Supreme Court discussed in Section 4. In order for the proposed Article 42a to have the intended effect, it should be rephrased to clarify that security provided for interim financing cannot be challenged if the money is used to make payments necessary for the continued operation of the business in view of the achievement of a composition.

It is noted that the justification of the proposed safe harbor may be called into question, given that both a clearly defined moment from which the safe harbor applies and a check on the feasibility of the proposed plan are lacking. A better solution might be to subject secured interim financing to prior scrutiny by the court.⁵⁹ The effect of court approval of the secured interim financing will not only be that the transaction is immune to an avoidance claim: court approval will also eliminate the liability risk for company directors involved in the transaction.

In addition to the issue of attracting new secured financing, it has recently been discussed whether the WHOA should offer protection to directors who, while preparing and negotiating the restructuring plan, will be involved in new obligations incurred and se-

⁵⁹ F.M.J. Verstijlen, Flankerende voorzieningen in de Wet Homologatie onderhands akkoord ter voorkoming van faillissement, in: A.C.P. Bobeldijk a.o., *Het dwangakkoord in faillissement*, Preadvies van de Vereniging 'Handelsrecht', Zutphen: Uitgeverij Paris, 2017, p. 121.

lective payments made by the company when it is foreseeable to them that the company will not be able to continue to pay (all) its due debts (in full). Josephus Jitta has suggested that the WHOA should shield directors from personal liability for as long as they can reasonably expect (i) that a majority of each class will vote for the plan or, in the event that a cross-class cram down is necessary, that the court will confirm the plan, and (ii) that financing for the plan can be attracted by the debtor.⁶⁰ Verstijlen, on the other hand, sees no reason to introduce a statutory 'safe harbor' shielding directors from personal liability for trading during the period when they are negotiating a restructuring plan under the WHOA. Verstijlen notes that directors are protected by the high threshold for personal tort liability of company directors ('serious reproach') introduced by the Dutch Supreme Court. Furthermore, he submits that the stage where directors' duties to creditors arise will not have been reached when a well-founded restructuring plan has been proposed. Finally, Verstijlen argues that the interests of outsiders are not subordinate to the restructuring process, of which they, generally, have no knowledge. During this process, they may expect the directors to observe duties of care owed to third parties.⁶¹ Although Josephus Jitta and Verstijlen disagree on the need for statutory protection, materially their views do not really differ that much. In essence, both take the view that directors should not be liable for business decisions made in the context of a viable restructuring plan. It is submitted that, even if a provision as suggested by Josephus Jitta is adopted in the WHOA, the question will still be whether the plan proposed by the directors was viable. It will be for the court to assess, on the basis of the facts and circumstances of the particular case, whether directors could *reasonably expect* the plan to be accepted and the necessary financing to be provided.

6 COMPANY RESCUE AND DIRECTORS' LIABILITY RISKS

In Dutch practice, the following liability claims are typically⁶² brought against directors of insolvent companies:

- Claims for the full deficit brought by the liquidator, based on a number of provisions simultaneously (Art. 2:9, Art. 2:138/248 and Art. 6:162 DCC), the essence of the claim being that the company has been (manifestly) mismanaged;

60 M.W. Josephus Jitta, 'Een aantal niet primair faillissementsrechtelijke aspecten van het Voorontwerp', in A.C.P. Bobeldijk *et al.* (Eds.), *Het dwangakkoord buiten faillissement*, Preadvies van de Vereniging 'Handelsrecht' 2017, Zutphen: Uitgeverij Paris, 2017, pp. 155-156.

61 F.M.J. Verstijlen, 'Flankerende voorzieningen in de Wet Homologatie onderhands akkoord ter voorkoming van faillissement', in A.C.P. Bobeldijk *et al.* (Eds.), *Het dwangakkoord in faillissement*, Preadvies van de Vereniging 'Handelsrecht', Zutphen: Uitgeverij Paris, 2017, p. 130.

62 Claims for involvement in the unlawful withdrawal of assets (including distributions to shareholders) are also quite common, but will not be further discussed in this report.

- *Beklamel*-claims brought by so-called ‘new’ creditors (those creditors with whom the company entered into agreements after the ‘moment of truth’);
- Tort claims brought by the liquidator or by an individual creditor against directors for making ‘selective’ payments or allowing these to be made on behalf of the company.

The first type of claim will not be discussed in more detail in the following sections because the focus of this report is on scenarios in which directors have not engaged in behaviour that qualifies as manifest mismanagement and that is an important cause of the bankruptcy. It should be stressed, though, that directors involved in a rescue attempt should at all times make sure that they have kept proper accounts and that the annual accounts are published in time, to avoid being confronted by the liquidator with the irrebuttable presumption of manifest mismanagement in the event the rescue attempt fails.

Legal advisors involved in the Dutch restructuring and insolvency practice frequently have to advise clients on the other two categories of director liability claims. Allowing the company to continue to trade and making/allowing selective payments are the key director liability issues arising in restructuring attempts prior to the opening of bankruptcy proceedings as well as in the preparation of a going concern asset sale using bankruptcy proceedings. When the company is on the brink of insolvency, directors want assurance that they can enter into new obligations on behalf of the company and they want to know to what extent they can selectively pay creditors without running the risk of being held personally liable.

6.1 *Director Liability for Continuing to Trade after the ‘Moment of Truth’*

Dutch law does not require directors to file for the opening of insolvency proceedings when the company is cash flow or balance sheet insolvent. In fact, the introduction of such an obligation would entail a fundamental change in Dutch company law, as Article 2:136/246 DCC provides that the board of directors may not file a bankruptcy petition without a mandate from the general meeting.⁶³ Neither does Dutch law contain a specific provision aimed at preventing wrongful trading. This does *not* mean, however, that Dutch law does not contain any instruments aimed at preventing directors from allowing companies to trade at the expense of its creditors. On the contrary: in the event that directors have engaged in trading after the ‘moment of truth’, two types of claims can be brought, which are both based the tort of negligence (Art. 6:162 DCC).

The first option, tried and tested in Dutch practice, is the *Beklamel*-claim mentioned in Section 3.4.2. For a successful claim, the plaintiff needs to show that the director *knew*

⁶³ In practice this provision can be circumvented by filing for suspension of payments (for which approval of the GM is not required) or by asking a creditor to file.

or should have known that the company would not be able to perform (and would not offer recourse) when he allowed the company to incur an obligation, in other words: that the director knew that the so-called 'moment of truth' had arrived. If the claim is successful, the plaintiff can claim the 'reliance loss' she suffered. The legal debate in these cases usually focuses on the 'moment of truth'. Although the burden of proof rests on the plaintiff, the court may decide to impose a duty on the defendant director to substantiate his assertion that there was no reason to believe that the company would not be able to fulfill the obligation (and would not offer recourse for the claim), by giving the court insight into the financial status of the company at the time of the transaction.⁶⁴ If the defendant director fails to come up with this information, he will lose the proceedings. It is therefore important for directors to 'get their story straight' before they decide to allow the company to continue to trade when its solvency is at risk. They are well advised to seek expert advice and to have an (expert) report drafted in order to be able to substantiate that the solvency prospects were such that they could reasonably continue to trade.⁶⁵ Dutch practice shows that the *Beklamel* line of case law poses a real threat to directors and is a strong incentive for directors to file for bankruptcy or seek advice on the possibility of restructuring.⁶⁶ Therefore, the conclusion in a recent study that the Netherlands is a member state lacking sanctions for wrongful trading is misleading.⁶⁷

The second option, which is the subject of debate in doctrine⁶⁸ and not often used in practice, is for the liquidator to bring a negligence claim against the directors for 'rate reduction loss'⁶⁹ caused to the joint creditors. The proceeds of such a claim must be paid to the estate and distributed by the liquidator.

64 DSC 27 November 1998, NJ 1998/148 (*Veenbrink/Baarsma*).

65 It is noted that if directors use experts to help them in making the decision to continue to trade, they will still be under a duty to use their own judgment. See M. Mussche (*Vertrouwen op informatie bij bestuurlijke taakvervulling*, Uitgaven vanwege het Instituut voor Ondernemingsrecht, Deel 83, Deventer: Kluwer, 2011) on the conditions that must be fulfilled for a so-called 'reliance defense' to be successful.

66 Y. Borrius, 'Directors' Liability: The Netherlands', *ECL* 2011, p. 251: "This type of liability urges management to take action to avoid the risk of liability if fundamental cash flow problems are foreseen".

67 *Study on a New Approach to Business Failure and Insolvency – Comparative Legal Analysis of the Member State's Relevant Provisions and Practices*, University of Leeds, 2016, available at: <http://bookshop.europa.eu/en/home>, table 2.1. at 60. This example shows that conclusions in comparative studies should not be taken at face value.

68 See V.R. Vroom and L.J.J. Kerstens, 'Wie de botte bijl hanteert komt de man met de hamer tegen', in Ph. W. Schreurs *et al.* (Eds.), *De gereedchapskist van de curator*, Insolad Jaarboek 2015, pp. 106-110.

69 This means that the liquidator has to calculate, for each creditor, the difference between the rate received in the insolvency proceedings and the rate the creditor would have received in case of timely filing. This corresponds to the damage the German trustee can claim in case of a violation of the duty to file prescribed in Para. 15a Insolvency Statute (the so-called 'Quotenschaden' (lit.: 'percentage damage')). See the report by Rolf Leithaus.

6.2 Director Liability for ‘Selective’ Payments Made after the ‘Moment of Truth’

A form of director liability that is much discussed in the Netherlands is the tort liability of company directors for engaging in ‘selective’ (preferential) payments of due debts. There is an obvious link between this liability and the corresponding transaction avoidance and bankruptcy fraud provisions discussed in Section 4. As has been explained in Section 4, Article 47 DBA only allows for the avoidance of due payments if (a) *the creditor knew that the debtor had already filed for bankruptcy when the payment was made* or (b) *creditor and debtor colluded to give a preference*. In other words: a payment of a due debt is lawfully made in the absence of the creditor’s knowledge of the filing or a conspiracy between debtor and creditor. This does not mean, however, that a director can never be personally liable for involvement in the payment of a due debt in the absence of the circumstances mentioned in 47 DCC. Article 47 DCC prescribes under which strict conditions a transaction can be avoided; it does not codify the duties of a company director when deciding whether or not to give a preference when the company is on the brink of insolvency. It was pointed out in Section 4 that such a duty is codified in Article 343 of the Dutch Criminal Code: a director may not unlawfully prefer any creditor of the company prior to the opening bankruptcy proceedings, if he does so *knowing that one or more creditors of the company will be prejudiced*. Article 343 Dutch Criminal Code aims to protect the interests of the creditors. If a director violates this ‘Schutznorm’, he also commits a tort toward the creditors that can be attributed to him (because he acted with constructive intent).⁷⁰ So, when they *know* that one or more creditors will be prejudiced, company directors must place the creditors’ interests above other interests by only making payments in accordance with the *pari passu* principle. The next question is whether directors only violate the *civil law* duty they owe to creditors when they make the payments with the *constructive intent of causing prejudice to creditors*. Or is the threshold for civil liability lower?

In the case *Coral/Stalt*, which was decided in 1998, the Supreme Court accepted that directors⁷¹ may be held liable for negligence if they allow the company to selectively pay a due and payable debt to a *related* party if there are *serious reasons to expect a deficit*.⁷² The Supreme Court restricted this judgment to cases of preferential payments to related parties and refrained from holding that there is a more general duty for directors to refrain from preferential payments in ‘the twilight zone’.

70 See also F.M.J. Verstijlen, ‘Bestuurdersaansprakelijkheid in het gemene recht’, in *Geschriften vanwege de Vereniging voor Corporate Litigation 2014-2015*, Serie vanwege het van der Heijden Instituut, Deel 128, Deventer: Kluwer, 2015, pp. 342-343.

71 The plaintiff in this case was a parent company, but the court’s reasoning starts with the duty of care that a director of a company has, transferring this to a parent company involved in the liquidation of its subsidiary.

72 DSC 12 June 1998, NJ 1998, 727 (*Coral/Stalt*). The plaintiff in this case was the only creditor who was left unpaid. Therefore, this case is more aptly categorized as a case of selective *non-payment*.

In the more recent case *Kok/Maas q.q.*,⁷³ a subsidiary company had made a payment of a due debt to its parent company, which was also its formal director. The sole shareholder and sole director of the parent company was Mr. Kok. The liquidator brought a negligence claim against Mr. Kok for allowing the payments to the parent company in his capacity as indirect director of the subsidiary. The money received by the parent company was used, inter alia, for payments in respect of management fees to Mr. Kok and his sons. The Dutch Supreme Court held that personal civil liability of the director for preferential payments can be incurred if the director

knew or should reasonably have understood that that the payments made by the company would have the consequence that the company would not be able to pay other debts nor be able to offer recourse for the damage resulting from the non-payment.

It is not clear from the judgment whether the fact that Mr. Kok and his sons stood to gain from the preferential payments may have played a role in the Supreme Court using the cited objective standard of knowledge (instead of requiring subjective knowledge). The Supreme Court has not yet ruled on a case where a director is made liable for allowing preferential payments to non-related parties without gaining anything from these payments.

The objective standard of knowledge cited in *Kok/Maas q.q.* has been used in several cases by lower courts in which payments had been made to non-related parties. In the context of these cases, the question arises whether a preferential payment can lead to personal liability if it was part of a feasible turnaround plan. It is submitted that there are two ways of approaching this question. The first is to argue that 'the moment of truth' has not yet arrived if the director is making the selective payments in an honest and reasoned attempt to save the company.

This is the approach that seems to have been taken in the case *Stoets Holding/Bohncke*,⁷⁴ in which case the Court of Appeal 's-Hertogenbosch held:

A director of a company in financial distress will have to stop trading if there is no reasonable option of continuing to trade. In the period preceding this moment, it can be expected of such a director to try to continue the business operations in some form. Part of such a rescue attempt will typically be to selectively pay the company's creditors to a certain degree; those parties necessary to safeguard the continued existence of the business, will be paid preferentially out of the need to survive. If the business is saved, ultimately all cred-

73 DSC 23 May 2014, *JOR* 2014/229 (*Kok/Maas q.q.*).

74 Court of Appeal 's-Hertogenbosch 19 January 2010, *JOR* 2010/113.

itors benefit from the selective payment. If the business fails, then it is not automatically given that the director acted negligently in making selective payments.

When judging with hindsight, the criterion must be whether the director – given the situation the company was in – could reasonably decide to resort to selective payments or whether he should have stopped trading.

The second approach is not to incorporate the possibility of a successful rescue attempt in the assessment of whether or not the ‘moment of truth’ has arrived. In this second approach, the fact that a serious rescue attempt is still an option does not stand in the way of assuming that the directors (should) know, in principle, that bankruptcy can (reasonably) be expected. However, if the preferential payments are necessary for the success of a serious rescue attempt, this may justify the violation of the *pari passu* principle by the directors.⁷⁵ In either of the two approaches discussed here, it is vital for directors to assess the viability of any rescue attempt (and to document this) before engaging in selective payments. Moreover, they will also have to show that the selective payments they made (or allowed to be made) were crucial for the success of the rescue attempt.

In the event that the director’s defense against a selective payments-claim fails, the liquidator can claim the loss suffered by the joint creditors as a consequence of the preferential payment. This means that the amount to be paid by the director cannot be more than the amount needed to make up for the difference in recovery rate caused by the preferential payment. A simplified example: company X has assets worth 200 and 4 creditors to whom it owes 100 each. The recovery rate is thus 50% for each of the creditors. If company X makes a preferential payment of 100 to one of the creditors, this leaves 100 for the remaining 3 creditors to share. Their recovery rate drops from 50% to 33.3%. To make up for this, the liquidator can claim what is necessary to restore the recovery rate to the original 50%, which is $150 - 100 = 50$.

7 SPECIFIC QUESTIONS

7.1 *To What Extent Does a General Duty Exist for Directors to File for Insolvency Proceedings under Certain Circumstances (e.g., Balance Sheet Insolvency, Inability to Pay)? Exceptions? Restricting Effect?*

As explained in Section 6.1 of this report, there is no statutory duty for directors under Dutch company or insolvency law to file a request for the opening of insolvency proceed-

⁷⁵ See C. Rijckenberg, in her comment on Court of Appeal ’s-Hertogenbosch, 19 January 2010, JOR 2010/113 (*Stoets Holding/Bohncke*). Rijckenberg takes the second approach.

ings at any point in time (and therefore no exceptions apply either). In the absence of such a duty, neither does Dutch statutory law contain a formal test (balance sheet or cash flow test) to define the moment when the directors should primarily have regard to the interests of the company's creditors. However, a shift from the directors' duty to act in the interest of the company and all its stakeholders to a duty to act in the interest of the company's creditors is reflected in Article 2:216 DCC, the statutory provision prohibiting directors of a BV from approving distributions to shareholders when they (should) foresee that the company will not be able to pay its debts as they fall due (see Section 3.1.3). Moreover, a shift in directors' duties is clearly reflected in the case law on personal liability of directors for violation of a duty of care owed to one or more creditors of the company. Well-settled case law shows that directors run the risk of incurring personal (tort) liability if they continue to trade after the 'moment of truth'. This will be further discussed in Section 7.2.

7.2 *Does a Prohibition on Wrongful Trading Exist and What Are the Consequences If a Business Is Continued Too Long?*

There is no specific statutory duty for directors under Dutch company or insolvency law to refrain from wrongful trading. However, as explained in Sections 6.1 and 6.2 of this report, directors must, at the risk of being held personally liable, take care not to violate a duty of care owed to the joint creditors or one or more individual creditors when they foresee that the company will not be able to continue to pay its debts and will not offer recourse. There are two main categories of behavior that may pose a liability risk for directors. The first main category is when a director caused or allowed the company to incur an obligation while she knows or should have known that the company would not be able to honor the obligation and would not offer recourse for the claim (*Beklamel* line of cases). The second main category is when the director has caused or allowed the company to make preferential payments while she knows (or should have known) that the company would not be able to pay its debts nor offer recourse ('selective payments' line of cases).

7.3 *To What Extent Do Directors Run Special Risks in the Context of a Restructuring When They Enter into New Obligations, Including New Secured Financing?*

Dutch practice evidences that the so-called *Beklamel* line of case law mentioned above poses a real threat to directors and is a strong incentive for directors to file for bankruptcy or seek advice on the possibility of restructuring. If directors choose the route of a restructuring attempt, it is vital that they 'get their story straight' before they decide to allow

the company to continue to trade when its solvency is at risk. If they do not do this and the rescue attempt fails, they will have a very hard time defending themselves against a negligence claim. On the other hand, it will be difficult for any plaintiff to prove that insolvency was imminent if the directors can submit a thorough report showing that the solvency prospects of the company were such that they could reasonably continue to trade. In this respect it should be mentioned that Dutch courts are generally reluctant to second-guess, with hindsight, the business judgment of directors if it is founded on adequate information.

If directors are involved in attracting new secured financing as part of a restructuring plan, they will perceive it as a risk that this transaction can be avoided if

at the time of performance of the act the opening of the insolvency proceedings and a deficit were foreseeable with a reasonable amount of probability for both the debtor and its counterparty (see Section 4).

In Dutch literature, the legal uncertainty to which this phrase gives rise has, understandably, primarily been discussed, and criticized, from the perspective of lenders and the companies in need of new financing. This report focuses on the more narrow perspective of the director focusing on the risk that she may be held personally liable. In this respect it is noted that directors can be held personally liable on the basis of Article 6:162 DCC for being involved in a transaction that prejudices the interests of the joint creditors. Because they are acting as company directors, representing the company in the transaction by means of which new secured financing is arranged, they will only be held liable if the standard of ‘serious reproach’ is met (see Section 3.2). Whether the court will judge this standard to be met depends on the facts and circumstances of the case. In the event that a director allowed security to be provided for new financing, a crucial factor will be the knowledge of the director that the transaction will diminish the recourse for other creditors. Pursuant to Article 343 Dutch Criminal Act, a director can be criminally prosecuted for unlawfully preferring any *creditor* of the company prior to the opening bankruptcy proceedings, if she does so *knowing that one or more creditors of the company will be prejudiced*. Because the lender is not yet a creditor (in respect of the new financing) when the ‘preference’ in the form of security is given, there can be no violation of Article 343 Dutch Criminal Code in this case.⁷⁶ This means that any civil liability of a director involved in providing security for new money can only be based on a non-statutory duty of care owed to the company’s creditors, provided that the standard of ‘serious reproach’ is met. This raises the question of when a director who is arranging new secured credit on behalf of the company runs the risk of a ‘serious reproach’ for violating a duty of care

⁷⁶ This is different in the event that the security is provided in respect of an existing debt.

owed to the joint creditors. If, similarly to the limit imposed upon the company and the lender, the director is required to refrain from the transaction if

at the time of performance of the act the opening of the insolvency proceedings and a deficit were foreseeable with a reasonable amount of probability for both the debtor and its counterparty,

this may have a chilling effect on restructurings, if no further guidance is given as to what 'a reasonable prospect' means. Directors of companies in the 'zone of insolvency' should enjoy some discretion to provide security for new financing in the context of a preventive restructuring plan, in particular to the extent that secured interim financing is necessary for the company to survive the period of time involved in negotiations, the voting procedure and court approval of the plan. In this regard it is submitted that the carve-out from Article 42 DBA proposed in the draft WHOA be replaced by a requirement that secured interim financing must be approved by the court. This would offer both lenders and directors of the debtor company the legal certainty they desire (see Section 5).

7.4 *To What Extent Do Directors Run Special Risks in the Context of Restructuring When They Engage in 'Selective Payment' (i.e., They Decide to Pay Certain Creditors and Leave Other Creditors Unpaid)?*

A risk that directors run when they are involved in a restructuring attempt is to be held liable for having allowed preferential payments to be made by the company ('selective payments'), particularly in the event that the attempt fails and the company is declared bankrupt. The key issue in these cases is from which moment on the director is no longer free to decide, on the basis of what she believes to be in the best interest of the company, which creditors with due and payable debts to pay and which to leave unpaid. Criminal law draws a clear line by providing that a director can be criminally liable for allowing a preferential payment *knowing that one or more creditors of the company will be prejudiced* (constructive intent). In civil law cases concerning 'selective payments', the courts tend to use an objective standard of knowledge. In a recent case, involving a preferential payment in a group relationship (from which the defendant director personally benefited), the Dutch Supreme Court held that personal civil liability of the director for preferential payments can be incurred if the director

knew or *should reasonably have understood* that the payments made by the company would have the consequence that the company would not be able to pay other debts nor be able to offer recourse for the damage resulting from the non-payment.

This objective standard of knowledge has been used in several cases by lower courts in which payments had been made to non-related parties.

In the context of this report, the key issue is whether a preferential payment can lead to personal liability of a director if the payment was part of a feasible restructuring attempt. It seems safe to conclude on the basis of relevant case law that the risk for a director to be held personally liable is remote if it can be established that the preferential payment was made in order to ensure the continuity of the company (see Section 6.2). Therefore, it is vital for directors to assess the viability of any rescue attempt (and to document this) before engaging in selective payments. If a claim for engaging in 'selective payments' is brought against them, they will not only have to be able to show that they were involved in a serious rescue attempt, but also that the litigious payments were necessary to make that attempt a success. What has been said about the general reluctance of Dutch courts to second-guess, with hindsight, business judgment based on adequate information in the context of *Beklamel*-cases also applies here.

7.5 *To What Extent Are Directors (Jointly and/or Severally) Liable for the Payment of Its Tax and Social Security Obligations?*

In the event that the company becomes insolvent and has not paid all its taxes, the tax collector can, just like any creditor who has not been paid by the company, bring a negligence claim against directors, claiming that the directors can be seriously blamed for violating a duty of care owed to the tax collector. In addition, Article 36 of the Tax Collection Act (TCA) enables the tax collector to bring a specific liability claim against *de jure* and *de facto* directors in respect of unpaid tax debts owed by the company. Such tax debts include wage withholding tax, VAT and excise tax debts. The regime codified in Article 36 TCA was introduced at the same time as Article 2:138/248 DCC and is similar in several respects. Directors are jointly and severally liable if non-payment of taxes owed by the company is due to 'manifestly improper management', with the possibility of individual exculpation. The 'manifestly improper management' must have occurred in the period of 3 years preceding the notice of inability to pay taxes ('melding betalingsonmacht') or, if they have not given such notice, 3 years before the company's first default in payment. In case of failure to timely and correctly notify the tax collector of the company's inability to pay, directors are presumed to be liable, unless they prove that they cannot be blamed for the failure to give notice and for the failure to pay the taxes that were due. A similar liability regime applies in respect of unpaid social security premiums and pension premiums payable to pension funds covering an entire industry.

8 ARTICLE 18 OF THE PROPOSED DIRECTIVE ON PREVENTIVE RESTRUCTURING FRAMEWORKS

In November 2016, the European Commission published its proposal for a directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU.⁷⁷ Somewhat surprisingly, given the considerable differences between member states' laws in respect of directors' duties and liabilities, this Proposal also aims to harmonize the duties of directors in connection with negotiations on a preventive restructuring plan. Article 18 of the proposed directive provides the following:

Member States shall lay down rules to ensure that, where there is a likelihood of insolvency, directors have the following obligations:

- a. to take immediate steps to minimize the loss for creditors, workers, shareholders and other stakeholders;
- b. to have due regard to the interests of creditors and other stakeholders;
- c. to take reasonable steps to avoid insolvency;
- d. to avoid deliberate or grossly negligent conduct that threatens the viability of the business.

According to the Explanatory Memorandum to the Proposal, rules on company directors' duty of care when nearing insolvency also play an important role in developing a culture of business rescue instead of liquidation, as they encourage early restructuring, prevent misconduct and avoidable losses for creditors.

In view of the fact that only bona fide restructuring attempts should be encouraged, it is understandable that Article 18 prescribes that directors should avoid misconduct and prevent avoidable losses to creditors. From a Dutch perspective, these issues can be addressed satisfactorily on the basis of existing Dutch law. This report shows that Book 2 of the DCC contains several provisions that aim to prevent misconduct by directors and avoidable losses for creditors. Egregious cases of misconduct can be dealt with by the newly introduced provisions on directors' disqualification and by the provisions on bankruptcy fraud. So, there is no need for the Dutch legislator to draft implementing legislation in respect of the obligation mentioned under (d) in Article 18 of the draft Directive.

The duties to take reasonable steps to avoid insolvency and to have due regard for creditors and other stakeholders (duties (b) and (c)) are reflected in the duty of Dutch company directors to fulfill their management task in the interest of the company and the business related to it. It is acknowledged that the duties of the company's creditors become paramount when insolvency looms. Moreover, negligence case law shows that company directors in the twilight zone owe duties of care to the company's creditors. If they

⁷⁷ COM(2016) 723 final.

violate these duties, they can be held personally liable for the damage caused to the creditors' interests by their negligence. Therefore, it seems that the Dutch legislator can also remain inactive in this respect. It may be noted that the tricky issue of from which moment on the directors must act primarily in the interest of the company's creditors seems to have been carefully avoided in Article 18. This means that member states will remain completely free to develop their own law in this regard.

From a Dutch perspective, the duty mentioned under (a) is problematic. Currently, there is no duty under Dutch law for directors, when there is a likelihood of insolvency, to take immediate steps to minimize the loss for creditors, workers, shareholders and other stakeholders. It is respectfully submitted that Dutch law will not be improved by the introduction of such a duty, simply because directors will not be able to equally minimize the losses for all the stakeholders mentioned. The problem that directors of financially troubled companies are faced with is that they cannot keep everybody happy and will have to make hard choices.⁷⁸ A vague duty that does not guide them in making these choices⁷⁹ serves no reasonable purpose and should therefore not be codified.

One of the aims of Article 18, according to the Explanatory Memorandum, is to encourage early restructuring. This aim is repeated in the preamble:

To further promote preventive restructurings, it is important to ensure that directors are not dissuaded from exercising reasonable business judgment or taking reasonable commercial risks, particularly where to do so would improve the chances for the restructuring of potentially viable businesses.

After reading these words, which raise high hopes of some guidance being provided to directors, it is rather sobering to see that Article 18 merely places duties on directors,⁸⁰ some of which are vague and others rather obvious, at least from a Dutch perspective. Article 18 will play no role in promoting preventive restructuring in Dutch law and practice.

78 See Reumers (The Business Rescue Craze in European Insolvency Law, *Ondernemingsrecht* 2017/95), who notes that Art. 18 does not tell directors 'how to balance the interests of all these stakeholders, and more to the point whether a director may decide that something has got to give'.

79 As Reumers (*Id.*) phrases it: "After all, if a director is 'being pulled at' from all sides by workers, shareholders, creditors and 'other stakeholders', he may well stay rooted to the spot".

80 Reumers (*Id.*) characterizes Art. 18 as a 'definite stick', as opposed to the 'carrots' provided by the obligation for member states to ensure that DIP proceedings are in place and that debtors negotiating a restructuring plan may benefit from a moratorium.

DIRECTORS' LIABILITY IN THE TWILIGHT ZONE: A BELGIAN LAW PERSPECTIVE, BETWEEN PRESENT AND FUTURE

NVR II REPORT

Stan Brijs and Arie Van Hoe*

*Help I'm steppin' into the twilight zone
The place is a madhouse
[Golden Earring]*

1 INTRODUCTION

1.1 *The Times They Are A-Changin'*

The objective of this contribution is to examine the topic of directors' liability in the twilight zone, from a Belgian law perspective. The question of directors' liability in or around insolvency has traditionally received a great deal of attention from Belgian legal scholars.¹ Now is, however, a particularly good time to revisit this topic, in light of two recent initiatives by the Belgian legislator. The first initiative is the global reform, by the Act of 11 August 2017, of Belgian insolvency law, which entered into force on 1 May 2018.² The second initiative is the draft bill fundamentally reforming Belgian company

* NautaDutilh Brussel.

- 1 We refer the reader to the following publications for a general overview of directors' liability under Belgian law: F. Helsen, 'Het actief van het faillissement – De aansprakelijkheid tegen bestuurders/zaakvoerders na discontinuïteit', in X., *Faillissement & Reorganisatie*, II.G.20-1-II.G.20, 118 p.; H. Braeckmans and R. Houben, *Handboek Venootschapsrecht*, Antwerpen, Intersentia, 2012, 331-374; J.-F. Goffin, *Responsabilité des dirigeants de sociétés*, Brussel, Larcier, 2012, 612 p.; M. Vandenberghe, *Aansprakelijkheid van vennootschapsbestuurders*, Antwerpen, Intersentia, 2009, 209 p.
- 2 The official Dutch title of the law reads as follows: "Wet van 11 augustus 2017 houdende invoeging van het Boek XX 'Insolventie van ondernemingen', in het Wetboek van economisch recht, en houdende invoeging van de definities eigen aan Boek XX en van de rechtshandhabingsbepalingen eigen aan Boek XX in het Boek I van het Wetboek van economisch recht". The Act was published in the Belgian State Gazette of 11 September 2017. Stan Brijs, one of the authors of the present contribution, was member of the restricted working group appointed by the Minister of Justice to prepare the reform.

law, which may be voted by the House of Representatives in the course of 2018.³ Both initiatives contain some important innovations with respect to directors' liability. The fact that both insolvency law and company law are relevant for directors' liability is testament to (and proof of) the idea (fact) that no real boundaries exist between these two branches of law.⁴

1.2 *Between Present and Future*

The focus of this contribution is on the future, namely what does the future hold for directors' liability under the new insolvency and company law? In order to better understand the innovations it is, however, useful to look at the present state of affairs.

1.3 *The Danger of the Twilight Zone ... and the Importance of Directors' Liability*

The immediate period before insolvency, referred to as the twilight zone, is a dangerous period for creditors of a company.⁵ It is at that particular moment in time, that shareholders have little left to lose (they are, in effect, 'out of the money').⁶ From an economic point of view, the creditors of the company have already become the owners of the company. Shareholders can therefore incite directors to embark on risky projects (at the expense of the creditors) in order to try to save some value for them.⁷ Rules on directors'

3 The draft bill was approved by the Council of Ministers on 21 July 2017 and sent to the *Raad van State* for advice. The *Raad van State* has advised on the draft bill in October 2017. It is expected that the revised draft bill will be submitted to the *Kamer van Volksvertegenwoordigers* before the summer of 2018. The draft bill has not yet been made public. The main elements of the draft bill, including the proposal to cap the directors' liability to a fixed amount, are, however, 'public knowledge'. Our comments are based on the draft bill approved by the Council of Ministers on 21 July 2017.

4 See, T. Bachner, *Creditor Protection in Private Companies*, Cambridge, Cambridge University Press, 7: "Company law and insolvency law do not operate as two islands with no bridges between them." See also, E.T. Bicker, *Gläubigerschutz in der grenzüberschreitenden Konzerngesellschaft. Eine international-privatrechtliche Untersuchung am Beispiel der abhängigen englischen Kapitalgesellschaft mit Verwaltungssitz in Deutschland*, Berlin, Duncker & Humblot, 2007, p. 53; J. Armour, 'Who should make corporate law? EC Legislation versus Regulatory Competition', in J. Holder and C. O' Cinneide (eds.), *Current legal problems 2005*, Oxford, Oxford University Press, 2005, p. (369) 402.

5 D. Bruloot, *Vennootschapskapitaal en schuldeisers*, Antwerpen, Intersentia, 2014, p. 503, n. 734.

6 T. Bachner, *Creditor Protection in Private Companies*, Cambridge, Cambridge University Press, p. 180: "The rationale underpinning these additional responsibilities towards creditors is that, once the shareholders' investment has been wiped out, the creditors replace the shareholders as residual risk-takers."

7 M. Olaerts, *Vennootschappelijke beleidsbepaling in geval van financiële moeilijkheden; de positie van bestuurders en aandeelhouders*, Antwerpen, Intersentia, 2007, p. 37: "In geval van (naderende) insolventie leidt de beperkte aansprakelijkheid tot wijzigingen in de vennootschappelijke verhoudingen. Bestuurders van een in financiële moeilijkheden verkerende onderneming hebben de neiging om over te gaan tot risicovol ondernemen teneinde, in een laatste reddingspoging, te trachten het tij te keren en op die manier het waardeverlies voor de aandeelhouders te beperken."

liability serve to counterbalance this gamble.⁸ By exposing directors to liability, they are forced to internalize⁹ the interest of creditors when determining the future of the company or, if they choose not to do so, personally bear the consequences of their decisions.¹⁰ The effectiveness of rules on directors' liability determines the protection of creditors of limited liability companies.

1.4 Scope

The scope of this contribution is limited to the external civil liability of directors in or around insolvency. We will not focus on the internal liability of directors vis-à-vis the company. It is a fact that this internal liability is rarely an issue (*see* Section 3.1.2). Nor will we deal with criminal liability of directors (although some aspects of criminal liability will incidentally be touched upon). The focus is on directors of the most frequently used limited liability companies, namely *naamloze vennootschappen/sociétés anonymes* and *besloten vennootschappen (met beperkte aansprakelijkheid)/sociétés privées (à responsabilité limitée)*.

1.5 Structure

The structure of this contribution is as follows. In the first section, we will briefly discuss the reform of Belgian insolvency and company law. In the second section, we will first set

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- 8 J. Armour, G. Hertig and H. Kanda, 'Transactions with Creditors', in *The Anatomy of Corporate Law. A Comparative and Functional Approach*, Oxford, Oxford University Press, 2017, p. (109) 114: "All our jurisdictions specifically deal with shareholder-creditor agency problems in relation to corporations that are financially distressed – that is, 'in the vicinity of insolvency'. The incentives for shareholders or managers to engage in value-decreasing transactions, such as asset substitution, become particularly intense when a firm's solvency is in doubt. Correspondingly, legal restrictions targeting corporations in financial distress are likely to have benefits. Moreover, lawmakers may view the costs as modest, because such provisions directly affect only a small subset of the firms in the economy."
- 9 J. Vananroye en G. Lindemans, 'Schuldeiserbescherming tegen misbruik van rechtspersonen: het insolventierecht geeft en het vennootschapsrecht neemt?', *D.A.O.R.* 2017, (4) 8: "Bestuurdersaansprakelijkheid leidt ertoe dat bestuurders in belangrijke mate de belangen van derden internaliseren: indien ze dat niet doen, riskeren ze immers door of ten behoeve van die derden aansprakelijk gesteld te worden. (...). Door de literatuur wordt over het algemeen te weinig benadrukt dat bestuursaansprakelijkheid ook, en wellicht vooral, de belangen van derden dient."
- 10 See, in general, about the normative function of tort law: M.J. Kroeze, 'Bange bestuurders', in *De vele gezichten van Maarten Kroeze's 'bange bestuurders'*, Deventer, Kluwer, 2017, (3) 4: "Wat is dan de nuttige functie van het aansprakelijkheidsrecht? Iemand die schade heeft geleden kan via een aansprakelijkheidsprocedure zijn schade vergoed krijgen. Minstens even belangrijk is dat degene die in een aansprakelijkheidsprocedure zijn recht haalt, daarmee tegelijkertijd een gedragsnorm handhaaft. Door hem wordt een sanctie gesteld op de maatschappelijke norm die de schadetoebrenger heeft geschonden. Daarmee stelt hij tegelijkertijd een voorbeeld voor anderen van wie zij verwachten dat zij dezelfde norm naleven. Die anderen zullen hun gedrag aanpassen om te voorkomen dat ook zij aansprakelijk worden gesteld."

out some general principles of directors' liability. Thereafter, we will discuss various rules on directors' liability under Belgian law as they are today, and as they will be in the near future. In the third section, we will answer some specific questions concerning directors' liability in (pre-)insolvency from a Belgian law perspective.

2 REFORM OF BELGIAN INSOLVENCY AND COMPANY LAW

2.1 *Reform of Insolvency Law*

2.1.1 **Some General Remarks**

With the recent reform of insolvency law, the Belgian legislator has followed the example of other European legislators that have reformed their insolvency law or are in the process of doing so. The first and most visible objective of the reform was the codification of insolvency law in an entirely new Book XX of the Code of Economic Law (*Wetboek Economisch Recht/Code de droit économique*). This codification did not entail a total makeover of insolvency law, although a great number of changes were made. A second objective of the reform, and one which will have an important practical impact, was to broaden the personal scope of application of insolvency law. This is done by replacing the antiquated concept of *handelaar* or *koopman/commerçant* with the new concept of *onderneming/entreprise*, for both reorganization and bankruptcy proceedings. The Insolvency Code will thus be applicable to all legal persons (apart from public law entities) and to all self-employed persons, even (under certain conditions) to organizations without legal personality. A third important objective was the full digitalization of insolvency proceedings: all filings and communications between courts, insolvency practitioners, creditors, etc. are done through the central electronic insolvency register. Other important innovations are new rules on second chance and rules to supplement the (Recast) Insolvency Regulation.

2.1.2 **Reorganization versus Liquidation Proceedings**

What does not change is the distinction between reorganization proceedings (*gerechtelijke reorganisatie/reorganization judiciaire*) on the one hand and bankruptcy proceedings (*faillissement/faillite*) on the other. While being part of the same Insolvency Code, the formal distinction between both types of proceedings is maintained. The purpose of reorganization proceedings is to preserve the continuity of the enterprise. This can be realized through (i) an amicable settlement (with at least two creditors), (ii) a reorganization plan voted by the relevant creditors and approved by the court or (iii) a total or partial sale of the company's activities and assets going concern under Court supervision. The purpose of bankruptcy proceedings, on the other hand, is to liquidate the assets of

the company.¹¹ In principle, this is done through a piecemeal sale of the assets, although exceptionally this can be done through a (global) sale in going concern.

2.1.3 Directors' Liability

With respect to the specific topic of directors' liability, the following elements of the reform of Belgian insolvency law are relevant to mention:

- The relocation of the rules on directors' liability after bankruptcy from company law to insolvency law. The motivation for this move is twofold. From a conceptual point of view, it indeed makes more sense to place the rules on directors' liability following bankruptcy in the insolvency code, as a chapter on bankruptcy. From a policy point of view, it was considered wise¹² to locate the rules on directors' liability after bankruptcy in the insolvency code, in order to apply them to foreign companies who have their centre of main interests (COMI) in Belgium;¹³
- The introduction of a formal wrongful trading provision (hereafter Section 3.1);
- Changes to the liability in case of manifest gross negligence contributing to the bankruptcy (hereafter Section 3.4);
- Changes to the liability for shortcomings in tax and social security payments (hereafter Section 3.3.6).

11 The purpose of the bankruptcy procedure is for the first time explicitly defined in the new Insolvency Code: "De faillissementsprocedure strekt ertoe het vermogen van de schuldenaar onder bevoegdheid van een curator te plaatsen die belast is het vermogen van de gefaillieerde te beheren en te vereffenen en de opbrengst ervan te verdelen onder de schuldeisers."

12 See on the (ir)relevance of the location of a rule in insolvency or company law, ECJ 10 december 2015 (*Kornhaas v. Thomas Dithmar*), case C-594/14, TRV-RPS 2016, 589 (with comments A. Van Hoe) and TBH 2016 (with comments H. De Wulf).

13 On the important topic of conflict of law rules and directors' liability, see C. Gerner-Beuerle, Ph. Paech and E. P. Schuster, *Study on Directors' Duties and Liability*, http://ec.europa.eu/internal_market/company/docs/board/2013-study-analysis_en.pdf, 2013, xvi: "(...) Member States rely on different legal mechanisms to disincentivise directors from trying to 'gamble' their way out of insolvency. Some of these mechanisms are situated outside traditional company law. In the jurisdictions examined, the application of Member States' conflict of law rules differ significantly in relation to such duties. In a large number of Member States, no clear consensus exists in legal practice or academia regarding the qualification of duties to file for insolvency. Such duties are sometimes qualified as company law rules, leading to the application of the company's home Member State. In other circumstances, such rules are qualified as falling within the area of tort law or insolvency law, which leads to the application of the law of the Member State where the company has its centre of main interest (COMI). In some Member States, a number of different interlocking legal strategies are classified, for private international law purposes, as belonging to different areas of law, leading to the application of such rules to foreign-incorporated companies."

2.2 Reform of Company Law

2.2.1 Some General Remarks

The existing Belgian company law is evaluated by many as being overly complex and burdensome. The main goal of the ambitious reform planned by the Minister of Justice Koen Geens, who himself is of course an esteemed professor in company law,¹⁴ is to attune Belgian company law to the ever-changing demands of economic reality, and to offer entrepreneurs a flexible framework to organize their affairs.¹⁵ As such, Belgium would be better placed in the regulatory competition, sparked by the case law of the Court of Justice, in the European market for company law.¹⁶ One of the more fundamental objectives of the reform is the intention to abolish the capital concept¹⁷ with respect to *besloten vennootschap met beperkte aansprakelijkheid*, which will become known as the *besloten vennootschap*.¹⁸ It is considered that the capital concept offers relatively little protection to creditors, while, on the other hand, constituting a limit on entrepreneurship.¹⁹ The abolishment of the capital concept has direct and important consequences for the rules on directors' liability.²⁰ Other important innovations are a reduction of the number of available types of companies and the adoption of the incorporation theory instead of the real seat theory.²¹

14 See, K. Geens, 'Een nieuw Wetboek van Vennootschappen en Verenigingen: *lean and mean, fit and proper?*', in *Quid leges sine cogitatione? Enkele reflecties over vennootschapsrecht aangeboden aan Jean-Marie Nelissen Grade*, Antwerpen, Biblo, 2011, pp. 74-103.

15 See on the various aspects of the reform, *De modernisering van het vennootschapsrecht*, Brussel, Larcier, 2014, 268 p.

16 See for a discussion of regulatory competition in company and insolvency law, A. Van Hoe, 'De reikwijdte van de vestigingsvrijheid in het vennootschapsrecht en het insolventierecht: convergentie of divergentie?', *TRV* 2012, pp. 65-80.

17 See on the origins and function of the European capital concept, D. Bruloot, *Vennootschapskapitaal en schuldeisers*, Antwerpen, Intersentia, 2014, pp. 9-21.

18 The capital concept is of course maintained in the *naamloze vennootschap*, due to European legislation.

19 See in this respect, J. Armour, G. Hertig and H. Kanda, 'Transactions with Creditors', in *The Anatomy of Corporate Law. A Comparative and Functional Approach*, Oxford, Oxford University Press, 2017, p. (109) 124: "It seems unlikely that minimum capital requirements on formation provide any real protection to creditors, as a firm's initial capital will be long gone if it ever files for bankruptcy. In addition, the reduction or abolition of minimal capital rules throughout Europe has been associated with an increase in entrepreneurship."

20 M. Wyckaert and F. Parrein, 'Een ongeluk komt nooit alleen. Hoe weegt de insolventie van de vennootschap op de bestuurdersaansprakelijkheid', in K. Geens (ed.), *Vennootschaps-en financieel recht*, Brugge, die Keure, 2011, (1) 20, n. 36: "Als alternatief voor de kapitaalregels wordt alle heil verwacht van ex post bestuurdersaansprakelijkheid, en ook de wrongful trading-regel wint daarbij aan belang."

21 For a general overview, see K. Maresceau, D. Bruloot and H. De Wulf, 'Het vennootschapsrecht aan de vooravond van een fundamentele hervorming: een eerste overzicht en evaluatie', *FLI Working Paper* 2018, www.law.ugent.be/fli/wps/pdf/WP2018-2.pdf.

2.2.2 Directors' Liability

Specifically with respect to the topic of directors' liability, the following aspects of the reform of Belgian company law are relevant:

- Confirmation by the legislator of the principle of managerial autonomy and judicial discretion (hereafter Section 3.1.1);
- Changes to the liability resulting from a decrease of net assets (hereafter Section 3.3.2);
- The (controversial) idea of a cap on directors' liability (hereafter Section 3.4).

3 DIRECTORS' LIABILITY: BETWEEN PRESENT AND FUTURE

3.1 Some Relevant General Principles

Like any other legal system, Belgian law knows a variety of legal grounds to hold directors liable. Before examining the present and future of these liability grounds, we discuss some general principles of directors' liability. These principles are relevant for the individual liability grounds discussed in the following.

3.1.1 Managerial Autonomy versus Judicial Restraint

Guiding a company, especially in times of financial distress, implies making difficult decisions, sometimes based on incomplete information. Under Belgian law, a clear distinction is made in this respect between the duty of a director and the duty of a judge. The duty of the former is *to direct*; the duty of the latter is *to judge*.²² When deciding upon the future of the company, directors have to act as a normally prudent and diligent director in the same circumstances.²³ The results of the decisions taken by directors can be either positive or negative. When judging the actions taken by directors, judges need to refrain from second-guessing the business judgment of directors, especially by taking into ac-

22 See, M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders*, Antwerpen, Intersentia, 2009, p. 66, n. 65: "De bestuurder oefent zijn functie onafhankelijk uit en geniet daarbij een zekere discretionaire beleidskeuze. Een normaal diligent bestuurder kan bij een confrontatie met bepaalde situaties immers verschillende houdingen aannemen die, hoewel erg van elkaar verschillend, elk op hun beurt niet als onzorgvuldig overkomen. De rechter die het gedrag moet beoordelen, mag dan ook zijn persoonlijke visie over wat nu de meest zorgvuldige handeling was geweest, niet opdringen, maar moet integendeel rekening houden met de pluraliteit van verschillende opties. Dat maakt dat de rechter de handelingen van de bestuurder slechts marginaal kan toetsen. Dat heeft als belangrijkste doelstelling te vermijden dat de rechter als een oneigenlijke beroepsinstantie fungeert tegen beslissingen van de raad van bestuur."

23 J.-F. Goffin, *Responsabilité des dirigeants de sociétés*, Brussel, Larcier, 2012, p. 104, n. 67: "A défaut de mieux, la doctrine et la jurisprudence choisissent de définir la faute par référence a contrario à un critère abstrait: le comportement de l'honnête homme normalement avisé et prudent, raisonnablement soucieux de ne pas causer du tort à autrui."

count the results of the decision (avoidance of any hindsight bias).²⁴ The concept of ‘marginale toetsing’ applies.²⁵

The twin principles of ‘managerial autonomy’ and ‘judicial discretion’ were already part and parcel of the Belgian case law on directors’ liability. In order to avoid any misunderstanding in this respect, the Belgian government has explicitly confirmed these principles in the Explanatory Memorandum to the draft bill reforming company law, in the following terms, which are worth quoting:²⁶

Er wordt rekening gehouden met het feit dat twee normaliter voorzichtige en toegewijde personen redelijkerwijs een andere houding kunnen aannemen. Dat is in het bijzonder het geval bij het beheer van een rechtspersoon. Een vennootschap besturen houdt steeds onder meer in dat men risicovolle beslissingen neemt of goedkeurt. Bovendien moeten bestuursorganen veel beslissingen in grote onzekerheid nemen, in omstandigheden waarin niemand op het moment van de beslissing kan bepalen welke beslissing een zorgvuldig persoon in dezelfde omstandigheden precies zou hebben genomen. Veel van de belangrijkste bestuursbeslissingen, bijvoorbeeld over strategische investeringen of desinvesteringen, behoren tot deze categorie, waarbij het bestuur over een ruime beleidsmarge beschikt. Hetzelfde geldt voor de wijze waarop het toezichtsoorgaan toezicht houdt op de directieraad, of de wijze waarop beide organen toezicht houden op en waken over de uitbouw van een behoorlijk systeem van interne controle en risicomanagement en desovereenkomstig hun controle uitoefenen. Men moet vermijden dat rechters aan wie wordt gevraagd te oordelen over bestuurdersaansprakelijkheid, op de stoel van het bestuur gaan zitten door opportuniteitsoordelen te vellen die alleen aan het bestuur zelf toekomen. Minstens even belangrijk is *hindsight bias* te vermijden, dat wil zeggen wijsheid na

24 Compare, M. Wyckaert and F. Parrein, ‘Een ongeluk komt nooit alleen. Hoe weegt de insolventie van de vennootschap op de bestuurdersaansprakelijkheid’, in K. Geens (ed.), *Vennootschaps-en financieel recht*, Brugge, die Keure, 2011, (1) 5, n. 8: “De rechter stelt zich terughoudend op bij de toetsing van het gedrag van een bestuurder. Diens gedrag wordt vanuit een ex ante-standpunt beoordeeld. Bovendien mag de rechter zijn eigen appreciatie niet in de plaats van het bestuur stellen. Hij sanctioneert enkel manifest ongerechtvaardigde gedragingen (marginale toetsing).”

25 D. Van Gerven, *Handboek Vennootschappen – Algemeen Deel*, Brussel, Larcier, 2016, p. 703, n. 359: “De rechter houdt zich aan een marginale toetsing van het gedrag van bestuurders, teneinde hun aansprakelijkheid ten aanzien van de vennootschap en derden te bepalen. De rechter eerbiedigt de beoordelingsmarge waarbinnen de bestuurder zelf gestalte geeft aan wat in het vennootschapsbelang is.”

26 Art. 2:52 of the draft bill reads as follows: “§ 1. Elke bestuurder, zaakvoerder, dagelijks bestuurder, lid van een directieraad of van een raad van toezicht is tegenover de rechtspersoon gehouden tot een behoorlijke vervulling van de hem opgedragen taak.” § 2. De in § 1 bedoelde personen en alle andere personen die ten aanzien van de rechtspersoon werkelijke bestuursbevoegdheid hebben of hebben gehad zijn jegens de rechtspersoon persoonlijk aansprakelijk voor fouten begaan in de uitoefening van hun opdracht. Zij zijn slechts aansprakelijk voor beslissingen, daden of gedragingen die zich kennelijk buiten de marge bevinden waarbinnen normaal voorzichtige en zorgvuldige bestuurders geplaatst in dezelfde omstandigheden redelijkerwijze van mening kunnen verschillen.”

de feiten waarbij uit de negatieve gevolgen van een bestuursbeslissing wordt afgeleid dat de beslissing als dusdanig onzorgvuldig was. Een wettelijke formulering van het beginsel van marginale toetsing kan tot de correcte beoordeling van bestuursbeslissingen bijdragen.

3.1.2 Internal versus External

A *summa divisio* is often applied between internal liability (directors' liability toward the company) and external liability (directors' liability vis-à-vis third parties). This distinction is certainly relevant because there are a number of important differences between actions introduced by the company and actions initiated by third parties. There are, however, a number of reasons why we chose not to apply this distinction in this contribution. First, internal liability actions are rarely applied in practice (it is indeed the shareholders who have appointed the directors, and frequently shareholders also act as directors).²⁷ Second, after bankruptcy, bankruptcy being the most important trigger for directors' liability actions, the distinction between internal and external liability loses most of its importance. Third, it is easier to give a comprehensible overview of the available liability actions by concentrating on the fault than on the question of whether the action can be introduced by third parties or by the company itself.

3.2 Action Rights of the Bankruptcy Receiver versus Those of the Individual Creditor

3.2.1 Principle

One of the more complex problems in insolvency law is the relationship between the bankruptcy receiver and the individual creditor as (potential) claimants. In *theory* the demarcation is simple. Only the bankruptcy receiver can initiate a claim with respect to damages that are considered to be *collective* to all creditors.²⁸ Inversely, (only) individual creditors can claim damages from directors for their own individual prejudice, to be distinguished from their stake in the collective prejudice suffered by all creditors.²⁹ In *practice* the determination of damage as being collective or individual is frequently disputed.

27 M. Vandenberghe, *Aansprakelijkheid van vennootschapsbestuurders*, Antwerpen, Intersentia, 2009, p. 2, n. 3: "Op het interne vlak heeft de bestuurder vaak een meerderheidspositie of zijn de contacten en vertrouwensbanden tussen meerderheid en bestuurder zo sterk dat een actio mandati slechts theoretisch is."

28 M. Wyckaert en F. Parrein, 'Een ongeluk komt nooit alleen. Hoe weegt de insolventie van de vennootschap op de bestuurdersaansprakelijkheid', in K. Geens (ed.), *Vennootschaps-en financieel recht*, Brugge, die Keure, 2011, (1) 15, n. 27.

29 See, J. Vananroye, 'Collectieve en individuele schade na faillissement: een kwestie van concrete schadebegroting', *RW* 2011-12, 371-374.

3.2.2 Exception

An important exception to this rule exists with respect to directors' liability for the company's debt in case of manifest gross negligence contributing to the bankruptcy (hereafter Section 3.3.5). Already before the 2017 reform, both the receiver and the individual prejudiced creditor could introduce this action.³⁰ By doing so, the individual creditor could exercise rights that in principle belong to the bankruptcy estate but only for his part therein.³¹ Under the new law, the relationship between the bankruptcy receiver and the individual creditor is regulated in a more detailed and refined way, granting more power to the individual creditor, thereby increasing the pressure on receivers not to stay passive (Art. XX.225). First of all, the individual creditor can actually exercise the bankruptcy receivers' action right, thus for the entire amount, in the interest of all creditors. The individual creditor who wants to introduce this action, must first invite the bankruptcy receiver to do so. If the bankruptcy receiver fails to introduce the action within one month after such notification, the individual prejudiced creditor can initiate the action himself. He must inform the bankruptcy receiver thereof. At all times, the bankruptcy receiver can change his mind and intervene in the proceedings in which case he automatically becomes the claimant by operation of law.

The legislator clearly wants to incentivize individual creditors to introduce these kind of actions, knowing that under the Belgian system of compensation of receivers, bankruptcy receivers show little appetite to invest in uncertain and protracted liability actions. The financial upside for individual creditors, apart from their expenses being reimbursed (if the action is successful), is that the proceeds of a favorable outcome of the liability action³² will be distributed among the creditors on a *pro rata parte* basis, eliminating the usual statutory and conventional rights of priority.³³ Large unsecured creditors can in this way recover a part of their damage, using powers that typically belong to the bankruptcy receiver.

3.3 Examination of the Various Liability Grounds

In most cases, the financial difficulties of a company develop gradually. Early financial difficulties can lead to a decrease of the net assets of the company. In order to find a solution for its difficulties, the company may try to reach an out-of-court agreement

30 M. Wyckaert and F. Parrein, 'Een ongeluk komt nooit alleen. Hoe weegt de insolventie van de vennootschap op de bestuurdersaansprakelijkheid', in K. Geens (ed.), *Vennootschaps-en financieel recht*, Brugge, die Keure, 2011, (1) 17, n. 30.

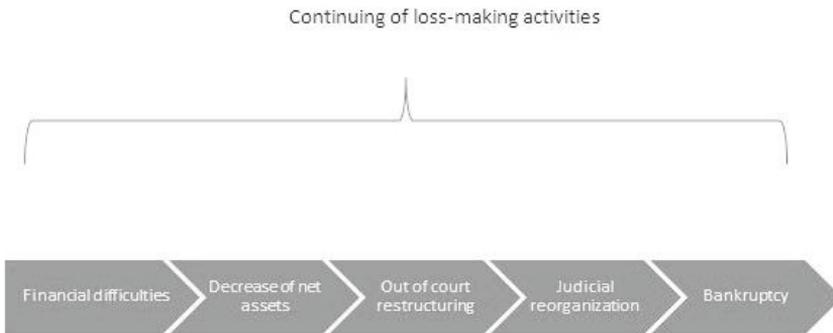
31 M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders*, Antwerpen, Intersentia, 2009, p. 166, n. 192.

32 If the liability is due to the dissipation of assets, the proceeds of the liability action will be distributed amongst the creditors, taking into account the statutory and conventional rights of priority.

33 A similar rule applies to the wrongful trading provision, which, however, can only be initiated by the bankruptcy receiver.

with its most important creditors. If this is not possible or successful, the company can resort to formal judicial reorganization proceedings. The last and final stage of the financial difficulties is bankruptcy. Throughout the development of the financial crisis, the directors of a company face different liability risks.

Figure Continuing of loss-making activities



3.3.1 Overview

Various grounds exist on which directors may be held liable under Belgian law vis-à-vis third parties for conduct in the vicinity of insolvency. The following liabilities are of particular relevance for directors in times of crises:

- liability resulting for not following the corporate rules in case of a decrease of net assets;
- liability for continuing loss-making activities;
- liability for late filing of bankruptcy;
- liability for the company's deficiency ('net debt') in case of manifest gross negligence contributing to the bankruptcy;
- liability for the company's social security debts unpaid upon the opening of the bankruptcy;
- joint liability for the company's advance tax payments or VAT payments.

3.3.2 Liability Resulting from Violating the Corporate Formalities Applicable in Case of a Decrease of Net Assets

3.3.2.1 Present³⁴

If the value of a company's net assets falls below 50% of its issued share capital, a general meeting must be convened by the board of directors within 2 months from the time the losses were or should have been reported. The purpose of this meeting is for the shareholders to determine whether the company should *either* continue its activities (and, in such event, it must adopt the necessary restructuring measures) *or* be liquidated. If a general meeting is not held within this 2-month period respecting all the formalities imposed (e.g., special report), the directors shall be liable for any damage sustained by third parties (typically creditors) as a result. Third parties do not need to prove the causality between the negligence of the directors and the damage they suffered. However, if directors duly perform the procedure set forth in the Company Code, as a rule, they cannot be held liable for the decisions taken by the shareholders' meeting, for instance if the latter decides to continue the activities of the company. Also, directors have sufficiently raised as a defense the fact, to be proven by them, that calling the general meeting of shareholders would not have made a difference.

3.3.2.2 Future

Due to the abolishment of the capital concept for *besloten vennootschappen (met beperkte aansprakelijkheid)*, it will no longer be possible to match the net assets of the company against the share capital. For these companies, the test as set out above is therefore reformulated, in order to make abstraction of the capital concept.³⁵ There is still a duty for the board of directors to convene a general meeting but the criterion (criteria) will be different: within 2 months from the time it determined that the net assets have become negative (or threaten to become negative)³⁶ *or* if the company threatens to become illiquid. The directors shall still be liable for any damage suffered by creditors as a result of

34 See, J.-F. Goffin, *Responsabilité des dirigeants de sociétés*, Brussel, Larcier, 2012, 247-260; M. Vandenberghe, *Aansprakelijkheid van vennootschapsbestuurders*, Antwerpen, Intersentia, 2009, 97-121.

35 Explanatory Memorandum: "Concreet wordt de alarmbelprocedure enerzijds aangepast in functie van het verdwijnen van het kapitaalconcept en wordt ze anderzijds op een aantal punten verbeterd."

36 Art. 5:133 of the draft bill reads as follows: "§ 1. Wanneer het nettoactief van de vennootschap negatief dreigt te worden of is geworden, roept het bestuursorgaan de algemene Vergadering bijeen binnen een termijn van ten hoogste twee maand nadat deze toestand werd vastgesteld of krachtens de wettelijke of statutaire bepalingen had moeten worden vastgesteld om te beraadslagen en in voorkomend geval te besluiten over de ontbinding van de vennootschap of over de maatregelen die nodig zijn om de continuïteit van de vennootschap te vrijwaren. (...)

§ 2. Op dezelfde wijze als bedoeld in § 1 wordt gehandeld wanneer het bestuursorgaan vaststelt dat het niet langer vaststaat dat de vennootschap volgens redelijkerwijs te verwachten ontwikkelingen in staat zal zijn om over een periode van minstens twaalf maanden haar schulden te voldoen naarmate deze opeisbaar worden."

not respecting this formality. The new tests to be applied by the directors appear more delicate than the old capital-based tests. The Explanatory Memorandum to the draft bill clarifies, however, that it is not expected of directors to apply the asset-or-liquidity test on a daily basis (which would indeed be very burdensome).

3.3.3 Liability for Continuing Loss-Making Activities

3.3.3.1 Present

Directors can be held liable toward third parties pursuant to the general principles of tort law (Art. 1382 of the Belgian Civil Code). Tort liability can, in general, be established (i) in case of breach of a specific legal norm or (ii) if a director does not comply with the general duty of care (to be) expected of a normal prudent and diligent person in the same circumstances.³⁷ This general rule of tort law is used to sanction among others the behavior of directors who knowingly continue loss-making activities, thereby damaging the interests of (new) creditors. Continuing an obviously insolvent enterprise constitutes a fault when there are no reasonable chances of recovery.³⁸ This does not imply, however, that continuing activities in difficult times automatically constitutes a fault.³⁹ Under certain circumstances, a normally prudent and diligent director can indeed decide to continue the activities of the company, e.g., based upon a new business plan, negotiations about an equity investment, a profitable new contract under negotiation, etc.⁴⁰ In judging the decisions taken by directors, courts have to exercise restraint. The facts must be judged based on the circumstances that prevailed at the time, and on the information that was available to the directors. Second, there can only be a fault if the contested decision falls beyond the margin of what careful and thoughtful directors could have divergent views on.

37 D. Van Gerven, *Handboek Vennootschappen – Algemeen Deel*, Brussel, Larcier, 2016, p. 719, n. 367.

38 M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders*, Antwerpen, Intersentia, 2009, p. 135, n. 159: “In een eerste fase moet de bestuurder de verlieslatendheid van de onderneming vaststellen en de ernst van de situatie beoordelen. Een activiteit kan immers slechts tijdelijk verlieslatend zijn, in welk geval de beëindiging ervan zeker en vast als een schending van het vennootschapsbelang en daardoor als bestuursfout kan gelden. Zodra echter vaststaat (of voor elke redelijke bestuurder vast zou moeten staan) dat er geen kans meer bestaat op herstel van de benarde financiële toestand en de schulden zullen blijven aangroeien en noodzakelijk tot het faillissement van de onderneming zullen leiden, vormt de voortzetting van dergelijke activiteit minstens een gemeenrechtelijke fout.”

39 M. Wyckaert en F. Parrein, ‘Een ongeluk komt nooit alleen. Hoe weegt de insolventie van de vennootschap op de bestuurdersaansprakelijkheid’, in K. Geens (ed.), *Vennootschaps- en financieel recht*, Brugge, die Keure, 2011, (1) 19, n. 34; J.-F. Goffin, *Responsabilité des dirigeants de sociétés*, Brussel, Larcier, 2012, p. 237, n. 150: “La poursuite de l’activité déficitaire n’engage la responsabilité des dirigeants à l’égard des tiers que si elle constitue une faute aquilienne, c’est-à-dire qu’elle s’écarte manifestement du comportement qu’aurait eu un dirigeant normalement prudent et avisé.”

40 Bergen 6 February 1979, *RPS* 1979, 75; Luik 29 October 1991, *RPS* 1992, 120.

This type of behavior (unreasonably continuing loss-making activities) has also been sanctioned in Belgian case law as manifestly gross negligence contributing to the bankruptcy (*see* Section 3.3.5).⁴¹

3.3.3.2 *Future, Wrongful trading*⁴²

What is new under the insolvency code is that the legislator has introduced a formal separate and specific statutory provision for sanctioning wrongful trading. Under this provision, a director or a person exercising the powers of a director will be liable if two conditions are fulfilled:

1. At a certain moment prior to the bankruptcy, the person knew or should have known that there was manifestly no reasonable prospect to save the company or its activities and to avoid bankruptcy.
2. From such moment on, the person has not acted like a normally prudent and careful director would have acted in the same circumstances.

Since this provision is new, its conditions have not yet been applied by the courts. A couple of points can, however, already be made here. First of all, the legislator's objective is not to nudge directors into not taking any risk anymore, even in times of financial distress. The provision itself confirms that the loss-making activity in itself is not sanctioned, only the continuation of the activities beyond the point where there was manifestly no reasonable prospect anymore and in that case only if the director has not acted like a normal careful director. The principle of 'marginale toetsing' will apply and this provision will therefore only sanction extreme cases. Indeed, the term 'manifestly' (*kenmerkend*) implies that there should be no reasonable doubt that there was no reasonable prospect to save the company and to avoid bankruptcy anymore. As is the case in other jurisdictions, it will be crucial for a director to take all steps but as important, to evidence the fact that she or he took these steps and on the basis of which information.

41 Kh. Charleroi 8 September 1992, *RRD* 1993, 29; Luik 13 January 2004, *DAOR* 2005, 144; Ghent 5 mei 2005, *TRV* 2005, 480. *See* in this respect, D. Bruloot, *Vennootschapskapitaal en schuldeisers*, Antwerpen, Intersentia, 2014, p. 553, n. 799.

42 For a discussion on the legal nature of wrongful trading, *see*, D. Bruloot, *Vennootschapskapitaal en schuldeisers*, Antwerpen, Intersentia, 2014, pp. 506-549; T. Bachner, *Creditor Protection in Private Companies*, Cambridge, Cambridge University Press, pp. 212-218. For a general discussion of wrongful trading, *see*, M. Olaerts, *Vennootschappelijke beleidsbepaling in geval van financiële moeilijkheden; de positie van bestuurders en aandeelhouders*, Antwerpen, Intersentia, 2007, pp. 229-263.

3.3.3.3 *Wrongful Trading versus Article 18 of the Proposed Directive*

Pursuant to Article 18 of the proposed directive on preventive restructuring frameworks,⁴³ the member states shall lay down rules to ensure that, where there is a likelihood of insolvency, directors have the following obligations:

- a. to take immediate steps to minimize the loss for creditors, workers, shareholders and other stakeholders;
- b. to have due regard to the interests of creditors and other stakeholders;
- c. to take reasonable steps to avoid insolvency;
- d. to avoid deliberate or grossly negligent conduct that threatens the viability of the business.

The introduction of a formal wrongful trading provision, together with the other liability grounds discussed in this section, can be considered as adequate to fulfil the obligation under Article 18 of the proposed Directive.

3.3.4 **Liability for Late Filing of Bankruptcy**

3.3.4.1 *Present*

A debtor is obliged to file for bankruptcy within 1 month after the suspension of payment (Art. 9 Bankruptcy Code). The failure to file for bankruptcy within this time frame does not, however, automatically result in a fault being committed by the directors of the company.⁴⁴ This is only the case if the director knew or should have known that the company was in a state of bankruptcy.⁴⁵ It can, however, be expected of a normal prudent and diligent director that (s)he is aware of the state of bankruptcy of the company. Directors who, knowingly, do not file for bankruptcy, expose themselves to criminal liability (Art. 498*bis*, 4 Criminal Code).

The obligation to file for bankruptcy is suspended by filing a request for the opening of reorganization proceedings. The suspension will end when such reorganization proceedings are terminated or when the request to open such proceedings is rejected (in appeal). This suspension indicates the 'wish' of the

43 Proposal of 22 November 2016 (2016/0359 (COD)) for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30 EU.

44 Cass. 22 December 1988, *Arr.Cass.* 1988-89, 91; Cass. 7 December 1990, *Arr.Cass.* 1990-1991, p. 18.

45 D. Van Gerven, *Handboek Vennootschappen – Algemeen Deel*, Brussel, Larcier, 2016, p. 730, n. 371: "De verplichting tot aangifte van faillissement rust op de vennootschap; de bestuurders kunnen enkel worden aangesproken als ze foutief hebben gehandeld, met andere woorden, indien ze wisten of behoorden te weten, dat de voorwaarden voor faillissement zijn vervuld en geen aangifte hebben gedaan."

legislator that companies first try to reorganize, before entering bankruptcy proceedings.

3.3.4.2 *Future*

No changes are to be mentioned in this respect (see Art. XX. 102 Insolvency Code).

3.3.5 **Liability for Manifest Gross Negligence Contributing to the Bankruptcy**

3.3.5.1 *Present*

In the event of bankruptcy, the bankruptcy receiver or any individual creditor may file a claim against the (former) directors of the company for manifest gross negligence contributing to bankruptcy (Art. 265 (BVBA) and Article 530 of the Company Code (NV)). Directors can be held personally and jointly liable for all or some of the company's deficiency or 'net debt' (i.e., the debts exceeding the assets of the bankrupt company), if it is proven that a manifest gross error was committed by said director(s), which contributed to the bankruptcy of the company. A manifest gross negligence is a behavior that appears (or should appear) to be a gross negligence for every reasonable director.⁴⁶ Continuing loss-making activities without taking measures to limit the losses, has been found to constitute a manifest gross error.⁴⁷

3.3.5.2 *Future*

The most important changes with respect to this liability action were already mentioned above (see subheading 'Exception' under Section 3.2). Under the new rules, an individual creditor will be able to exercise the bankruptcy receivers' action right, thus for the entire amount, in the interest of all creditors. In addition, the relationship between the bankruptcy receiver and the individual creditor is regulated in a more detailed and refined way, granting a genuine financial incentive to the individual creditor to initiate the action, if the bankruptcy receiver is unwilling to do so himself.

3.3.6 **Liability for Shortcomings in Payment of Tax and Social Security Contributions**

3.3.6.1 *Present*

Tax⁴⁸ and social security institution traditionally enjoy a (disputed) preferred position in insolvency through statutory liens, the possibility for the tax authority to take a lien, etc.

46 H. Braeckmans and R. Houben, *Handboek Vennootschapsrecht*, Antwerpen, Intersentia, 2012, p. 349, n. 631.

47 Luik 13 January 2004, *DAOR* 2004; Gent 24 October 2005, *TRV* 2005, 473.

48 M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders*, Antwerpen, Intersentia, 2009, p. 142, n. 169: "Waar ondernemingen failleren, duikt de fiscus steevast op met een schuldvoordering."

This preferential treatment of public creditors is reflected in certain specific rules on directors' liability.

3.3.6.2 *Special Liability in Case of Shortcomings in Advance Tax or VAT Payments*⁴⁹

Directors of a company may be held jointly and severally liable with the company for failure to pay corporate taxes or VAT (Art. 442quater of the Income Tax Code and Art. 93undecies C of the VAT Code). As a general rule, the directors can only be held liable if, while fulfilling their managerial duties, they committed a fault, e.g., continuing of loss-making activities (Art. 1382 Civil Code).⁵⁰ A presumption of fault is, however, created: if the company regularly fails to remit withholding tax or VAT, the directors shall be deemed to be at fault. The concept of regularity is defined as follows with respect to both withholding tax and VAT: three nonpayments per year, if the tax is due on a monthly basis, and two nonpayments over a one-year period if the company is subject to quarterly tax payments. This presumption can be rebutted if nonpayment is due to financial difficulties that trigger a composition with creditors, bankruptcy or involuntary dissolution.⁵¹

3.3.6.3 *Special Liability for Unpaid Social Security Contributions.*

A similar (but stricter) ground for liability exists for unpaid social security contributions. The Belgian Social Security Administration and the bankruptcy receiver may bring a claim before the Commercial Court to have the directors declared personally, jointly and severally liable for all or some of the social security contributions, increases, penalties and late payment interests, which are due at the moment of bankruptcy (Arts. 265, §2, (BVBA), 409, §2 (CVBA) and 530, §2 (NV) Company Code). Such liability will be triggered if either of the following conditions is met: (i) the director(s) clearly acted in a grossly negligent manner leading to the bankruptcy of the company or (ii) over the 5-year period immediately preceding the bankruptcy, the director was involved in two or more other bankruptcies, liquidations or similar situations in which social security contributions remained unpaid.⁵² It furthermore suffices that one director was involved in such prior bankruptcy proceedings. To somehow 'limit' the risk for directors, the Su-

49 See, F. Helsen, 'Het actief van het faillissement – De aansprakelijkheid tegen bestuurders/zaakvoerders na discontinuïteit', in X., *Faillissement & Reorganisatie*, II.G.20-76-II.G.85.

50 See, M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders*, Antwerpen, Intersentia, 2009, p. 155, n. 180.

51 M. Wyckaert and F. Parrein, 'Een ongeluk komt nooit alleen. Hoe weegt de insolventie van de vennootschap op de bestuurdersaansprakelijkheid', in K. Geens (ed.), *Vennootschaps-en financieel recht*, Brugge, die Keure, 2011, (1) 4, n. 5.

52 The Supreme Court has ruled that a bankruptcy opened on the same day as the last bankruptcy nevertheless qualifies as a prior bankruptcy, Cass. 7 April 2017, *TBH* 2017, 750 (with comments A. Van Hoe and K. De Smet).

preme Court has ruled that the court may take into account the good faith of directors, to determine the amount of the damages.⁵³

3.3.6.4 *Future*

The privileged position of tax and social security institution is maintained under the new insolvency code. The following changes can be mentioned.

The grounds for liability for social security contributions have been moved from social security laws to the Insolvency Code (Art. XX.226). The (remaining) trigger for this liability is the involvement by a director in two or more bankruptcies in the 5-year period immediately preceding the bankruptcy. This liability is further aligned with grounds for liability for gross misconduct by the director: any amounts awarded to the Social Security administration based on the general liability action for gross misconduct claimed by the receiver or an individual creditor must be deducted from the amount awarded under the specific liability ground for social security contributions.

As to shortcomings in tax and VAT payments, the existing mechanisms of Article 442quater of the Income Tax Code and Article 93undecies C of the VAT Code were maintained but coordinated with Articles XX. 225-227 of the Insolvency Code. As with the liability action for social security contributions, it is made clear that ‘double use’ of a claim for both gross negligence and tax liability is out of the question; both claimed amounts will henceforth be compensated (Art. 442quater, §7 of the Income Tax Code).

3.4 *Toward a Financial Cap on Directors’ Liability?*

Probably the most controversial element of the envisaged reform of company law, is the proposal to ex ante cap directors’ liability to a certain amount. Under the terms of this proposal, the liability of directors’ would be capped to a fixed amount, as a function of the economic size of the company. This limitation is justified by similar limitations for other economic professions (e.g., auditors) and employees.⁵⁴ Subject to changes in the course of the legislative process, five categories are for the moment distinguished under this proposal:⁵⁵

53 Cass. 24 March 2016, AR C.15.0166.N.

54 Explanatory Memorandum: “De voorgestelde regeling zorgt aldus voor een gelijke behandeling van bestuurders met deze andere groepen van professioneel actieve personen.”

55 Explanatory Memorandum: “De bedragen zijn zo gekozen dat de aansprakelijkheidsregels hun vergoedende en afschrikwekkende functie kunnen waarmaken, zonder er op gericht te zijn bestuurders persoonlijk te ruïneren. Het bedrag van de aansprakelijkheidsbeperking verschilt naargelang van de omvang van de rechtspersoon waarin de bestuurder een opdracht uitoefent. Grotere ondernemingen brengen een grotere maatschappelijke verantwoordelijkheid met zich mee, zodat hogere aansprakelijkheidsbedragen zijn verantwoord.”

Turnover of less than € 350,000 and balance total of € 175,000	€ 125,000
Turnover of less than € 700,000 and balance total of € 350,000	€ 250,000
Turnover of less than € 9,000,000 or balance total of € 45,000,000	€ 1,000,000
Turnover of less than € 9,000,000 and balance total of € 4,500,000	€ 3,000,000
Organizations of public interest, or turnover of € 50,000,000 and balance total of € 43,000,000	€ 12,000,000

The liability cap would be applied both internally (*vis-à-vis* the company) and externally (*vis-à-vis* third parties, in particular creditors), and irrespective of the precise ground for liability. The cap on liability would, however, not apply in cases of fraudulent intent. The cap on liability would also not apply with respect to liabilities for shortcoming in tax payments. In addition, it would no longer be possible for the company to internally (*vis-à-vis* the company) or externally (*vis-à-vis* third parties) *ex ante* limit or exclude the liability of directors. Companies could, however, still insure the liability of their directors.⁵⁶

The idea behind this proposal is among other things to further guarantee the insurability of directors' liability.⁵⁷ A cap on directors' liability is alleged to make it easier for insurance companies to calculate their risks, and set the premium accordingly. A well-functioning insurance market is to the benefit of both directors and victims. The proposal to cap directors' liability to a fixed amount is not free from criticism.⁵⁸

56 See, M. Vandebogaerde, *Aansprakelijkheid van vennootschapsbestuurders*, Antwerpen, Intersentia, 2009, p. 29, n. 34: "De vennootschap kan zelf de externe aansprakelijkheid van de bestuurder verzekeren. Hoewel op het eerste gezicht niet geheel duidelijk blijkt wat het belang daarvan precies is voor de vennootschap, kan er wel degelijk belang zijn. Zoals de wetgever, die poogde om de creativiteit en de originele, soms risicovolle beslissingen niet geheel aan banden te leggen, kan ook de vennootschap nog meer belang hebben bij een bekwame bestuurder die bepaalde risico's durft te nemen zonder verlamd te zijn door het aansprakelijkheidsrisico."

57 Explanatory Memorandum: "Door een cijfermatige aansprakelijkheidsbeperking in te voeren, zal de wetswijziging bovendien bijdragen aan een betere, blijvende verzekeraarbaarheid van het bestuurdersaansprakelijkheidsrisico. Het financiële risico waaraan de bestuurder blootstaat zal beter kunnen worden ingeschat, en zal daarom goedkoper verzekeraar worden."

58 J. Vananroye en G. Lindemans, "Schuldeiserbescherming tegen misbruik van rechtspersonen: het insolventierecht geeft en het vennootschapsrecht neemt? *DAOR*, 2017, (4) 12: "Bestuursaansprakelijkheid is een belangrijke rem op roekeloos gedrag dat de risico's verbonden aan een hogere winst afwettelt op schuldeisers. Die rem minder effectief maken, is een driest experiment." From a Dutch perspective, P. Broere and O. Oost, 'De mythe van bestuurdersaansprakelijkheid', *Ars Aequi* 2018, 275: "Een kwantitatieve aansprakelijkheidsbeperking is een creatieve, nieuwe richting voor het bestuurdersaansprakelijkheidsrecht. Die nieuwe richting overtuigt ons niet. Schadevergoeding is een zero sum game. Veroorzaakt een bestuurder schade en hoeft hij die slechts ten dele te vergoeden, dan zal de benadeelde of de vennootschap de rest moeten dragen."

4 SPECIFIC QUESTIONS

4.1 *To What Extent Do Directors Run Special Risks in the Context of a Restructuring When They Enter into New Obligations, including New Secured Financing?*

4.1.1 **General**

The fact that directors enter into new obligations on behalf of the company in a restructuring context is, as such, not a problem. Restructuring is done in a going concern context, and new obligations are an inevitable consequence of this context. Directors' liability has, however, been established in cases where the directors knew that the company would not be able to honor this new obligation.⁵⁹ Such behavior, if it includes consciously misleading of the creditor, can even be criminally sanctioned. However if the banks still granted credit at that moment, the director could not know that the company was in fact on the verge of bankruptcy and unable to meet new obligations.⁶⁰ In addition, courts do expect of creditors that they also examine the financial situation themselves.⁶¹

4.1.2 **Out-of-Court Restructuring**

In order to stimulate debtors and creditors to make use of amicable agreements without opening court proceedings, Article XX. 37 Insolvency Code protects the results of such agreements and actions taken in performance thereof under certain conditions, in a subsequent bankruptcy. Payments made by the debtor as well as (new) security granted for (old) debts, cannot be challenged by the bankruptcy receiver. In addition, it is expressly stipulated that creditors cannot be held liable because of the fact alone that the amicable agreement did not make the continuity of the enterprise possible. Although these provisions concern debtors and creditors and not the debtor's *directors*, one can reasonably argue that it will be very difficult to render directors liable, which requires wrongful behavior/negligence, for the same legal acts which are otherwise expressly protected by law in favor of the creditors.

4.1.3 **In-Court Restructuring**

First of all, it is important to point out that under Belgian law, formal reorganization proceedings are in principle debtor-in-possession proceedings. Since the directors are still in charge, they can thus enter into new obligations without court supervision. The fact that a company is temporarily protected against its creditors does not, however, result in

59 Ghent, 7 June 2001, *JDSC* 2003, p. 717.

60 Bergen 3 November 2003, *JLMB* 2005, p. 245.

61 Ghent, 7 June 2001, *JDSC* 2003, p. 717.

an ex post immunity for directors, especially since the threshold to enter such proceedings is rather low.⁶² Second, bona fide creditors of new obligations enjoy certain types of protection. Securities established during the reorganization proceedings cannot be challenged if a suspect period is later established in the bankruptcy (Art. XX. 51 Insolvency Code). Debts resulting from new obligations are qualified as *boedelschulden/dettes de la masse* in a subsequent bankruptcy or liquidation of the debtor (Art. XX. 58 Insolvency Code). The conclusion is therefore that while in theory, formal reorganization proceedings do not bring immunity to directors, the opening of such proceedings will make it very difficult to establish directors' liability for having the company enter into new obligations.

4.2 *To What Extent Do Directors Run Special Risks in the Context of Restructuring When They Engage in 'selective payment'?*

4.2.1 **General Remarks**

Outside insolvency proceedings, Belgian law does not contain a general rule against selective payments. It is up to each creditor to monitor the financial situation of their debtor and, if necessary, insist on payment and take appropriate measures to obtain it (*ius vigilantibus*).⁶³ Selective payment of (important) creditors can sometimes even be in the interest of the continuity of the company.⁶⁴ This does not mean, however, that all payments are acceptable. Selective payments can constitute a fault judged against the criter-

62 J.-F. Goffin, *Responsabilité des dirigeants de sociétés*, Brussel, Larcier, 2012, p. 262, n. 170: "Le dirigeant ne pourrait dès lors plus tirer argument de la décision du tribunal d'ouverture de la procédure en réorganisation pour démontrer la possibilité de redressement de l'entreprise et, partant, l'absence de faute lors de la poursuite des activités déficitaires." S. Jacmain and C. De Boe, 'L'article 37 de la loi sur la continuité des entreprises: nouveaux développements et mise en perspective au regard de la responsabilité – en particulier en matière fiscale et sociale – des dirigeants d'entreprise', *TBH*, 2015, pp. 526-548.

63 J. Vananroye, *Organisatierecht: werfbezoek aan een onvoltooide piramide*, Antwerpen, Intersentia, 2015, p. 30, n. 15: "Het uitgangspunt is dat tot op het ogenblik van insolventie (of minstens het ogenblik waarop insolventie redelijkerwijze een onafwendbaar risico wordt) een schuldenaar het gelijkheidsbeginsel niet dient te respecteren. Dit geldt a fortiori voor andere schuldeisers: voorafgaand aan de samenloop geldt het jura vigilantibus-principe ('het recht is er voor de wakkeren'), niet de gelijkheid tussen schuldeisers. Het is met ander woorden normaal en legitiem dat een schuldeiser tracht voor te kruipen, ook als insolventie een realistisch risico lijkt en zelfs als de schuldenaar een negatief eigen vermogen heeft, maar er nog een realistische kans is op herstel." See in general on the duties, if any, of a creditor vis-à-vis another creditor, E. Dirix, "Is een schuldeisers zijn broeders hoeder?" in *Liber Amicorum Lucien Simont*, Brussel, Bruylant, 2002, pp. 371-384.

64 D. Van Gerven, *Handboek Vennootschappen – Algemeen Deel*, Brussel, Larcier, 2016, p. 726, n. 370: "De rechter toetst de beslissing van de bestuurder aan het gedrag van een vooruitziend en zorgvuldig bestuurder geplaatst in dezelfde omstandigheden. In de praktijk moet de bestuurder aantonen dat hij niet kon betalen wegens tijdelijke betalingsmoeilijkheden. Er geldt daarbij geen verplichting de schuldeisers gelijk te behandelen; maar een ongelijke behandeling moet in het vennootschapsbelang zijn verantwoord, zoals wanneer de noodwendigheden van de bedrijvigheid vereisen dat een bepaalde schuldeiser sneller dient te worden betaald."

ion of a normally careful and prudent director. For example, payments made without any appropriate business rationale can constitute negligence, and thus fault.⁶⁵

4.2.2 Out-of-Court Restructuring

Referring to what was explained in Section 4.1, payments made under an amicable agreement are protected against avoidance actions from the bankruptcy receiver. This will also make it more difficult to establish directors' liability for the same payments.

4.2.3 Reorganization Proceedings

Once formal reorganization proceedings are opened, there is (still) no general principle of creditor equality (unlike in bankruptcy proceedings). The debtor in possession can thus, in principle, engage in 'selective payment'. The legislator has, however, rightfully set an important limit to this freedom. Selective voluntary payment of certain creditors needs to be necessary for the continuity of the business. If this criterion is respected, the payment will be protected against certain avoidance actions of the bankruptcy receiver. Indeed, payments for non-due debts or payments other than money payments or payments received by creditors who were or ought to have been aware of the cessation of payments, are not subject to the avoidance actions that are normally possible if they took place in the 'suspect period'. However, a fraudulent conveyance action ('actio pauliana') always remains possible.

4.3 To What Extent

4.3.1 Does a General Duty Exist for Directors to File for Insolvency Proceedings under Certain Circumstances (e.g., Balance Sheet Insolvency, Inability to Pay)?

A general duty to file for bankruptcy within 1 month after the suspension of payment exists (Art. 9 Bankruptcy Code). This duty and the directors' liability that can flow from it have been discussed in Section 3.3.4.

4.3.2 Do Exceptions to the General Duty as Mentioned in Item (a) Exist?

The obligation to file for bankruptcy is suspended by filing a request for the opening of reorganization proceedings. This 'exception' is discussed in Section 3.3.4.

65 E. Dirix, 'Grenzen van de wilsautonomie inzake zakelijke zekerheidsrechten', in *Bijzondere overeenkomsten, Postuniversitaire cyclus Willy Delva 2007-2008*, Kluwer, 2008, pp. 148-149: "De afwezigheid van een samenloop situatie laat de debiteur in beginsel toe om tussen zijn schuldeisers te discrimineren. [...] Dit sluit echter niet uit dat onder omstandigheden een selectieve betaling onrechtmatig kan zijn ingeval de schuldenaar niet meer in staat is al zijn schuldeisers te voldoen."

4.3.3 Do the Rules Addressed in Items (a) and (b) Have a Restricting Effect in Practice?

Yes, they do. This duty and the 1-month period are generally well known. Debtors as well as creditors use this deadline, which is criminally sanctioned, to their favor in negotiations to put pressure on the other party. Obviously, defining the moment where the 1-month period starts remains a subjective exercise in a gray zone; in addition, the risk of a court establishing the starting moment too early, can to some extent be influenced by the directors by establishing the right evidence showing that there was still credit and that payments were still being made.

4.3.4 Does a Prohibition on 'Wrongful Trading' Exist and What Are the Consequences if a Business is to Continue Too Long?

A specific wrongful trading provision has been introduced in Belgian law by the Act of 11 August 2017 introducing the new Insolvency Code, applicable to proceedings opened after 1 May 2018. This provision has been further discussed in Section 3.3.3.

4.3.5 To What Extent are Directors (Jointly and/or Severally) Liable for the Payment by the Company of Its Tax and Social Security Contributions?

There is a specific directors' liability for the debtor's failure to pay tax and social security contribution. It is discussed in Section 3.3.6.

5 CONCLUSION

In his inaugural address, professor Kroeze described the phenomenon of scared directors ('bange bestuurders').⁶⁶ At the end of this contribution, we can try to answer the question whether directors can enjoy a good night's sleep or, instead, should stay awake pondering decisions. The answer to such a question can only be a nuanced one. Belgian law clearly recognizes the autonomy of directors to direct the company as they see fit. Failures will therefore not automatically result in directors' liability. Courts are expected to exercise restraint when judging decisions taken by directors. There are, however, real risks involved in directing a company in financial distress. Once a company enters into financial difficulties, directors must (also) take into account the interests of creditors. Failure to do so can result in directors' liability. Paying increased attention to the company's situation and evidencing which steps have been taken and which available information these steps were based on, will be helpful in avoiding unpleasant surprises before the court.

⁶⁶ M. J. Kroeze, 'Bange bestuurders', in *De vele gezichten van Maarten Kroeze's 'bange bestuurders'*, Deventer, Kluwer, 2017, pp. 3-31.

The reforms of insolvency and company law do not fundamentally change the position of directors. The behavior sanctioned (unreasonably continuing loss-making activities) by the new wrongful trading provision, although it was previously sanctioned through other existing mechanisms, will receive more attention from directors. The explicit confirmation by the legislator of the principles of 'managerial autonomy' and 'judicial discretion' will strengthen the position of prudent directors. As to the proposal to cap directors' liability, should it be enacted, its effects on the behavior of directors will have to be carefully examined in the future.

A GERMAN LAW PERSPECTIVE ON DIRECTORS’ LIABILITY IN THE VICINITY OF INSOLVENCY

NVR II REPORT

Rolf Leithaus and Christian Lange

1 INTRODUCTION

Down to the present day, no EU law stipulation concerning an obligation to request for the initiation of insolvency proceedings, a key issue of wrongful trading, has come into effect. Nevertheless, already in 2001 the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, appointed by the EU commission, recommended that

a rule on wrongful trading should be introduced at EU level, which would hold company directors (including shadow directors) accountable for letting the company continue to do business when it should be foreseen that it will not be able to pay its debts.¹

A small step in this direction is now taken by Article 18, para. a of the “Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures” (‘Proposal’), to be treated at a later stage in this report.²

However, as one of only a few legal systems, German law already provides for a strict obligation of company directors of legal entities such as a Limited Liability Company (*Gesellschaft mit beschränkter Haftung*, GmbH) to petition for insolvency proceedings if the company is deemed insolvent under German insolvency law and combines this obligation with personal and criminal liability of a company director not acting accordingly. By this measure, the German legislator attempts to avoid wrongful trading by company directors at an early stage. Until November 2008, such obligation for directors was in-

1 Cf. Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, dated 4 November 2002, p. 12, http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf.

2 See Section IV.

corporated in the respective company acts, e.g., the Limited Liability Companies Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung*, GmbHG),³ the Stock Corporation Act (*Aktiengesetz*, AktG)⁴ or the Commercial Code (*Handelsgesetzbuch*, HGB).⁵ By coming into effect of the “Law for the Modernization of the German Limited Liability Company Law and the Prevention of Misuse” (*Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen*, MoMiG), a general duty for directors of corporations has been incorporated in Section 15a para. 1 of the German Insolvency Code (*Insolvenzordnung*, InsO). This rule now reads as follows:

Where a legal person becomes illiquid or over-indebted, the members of the board of directors or the liquidators shall file a request for the opening of proceedings without culpable delay, at the latest, however, three weeks after the commencement of insolvency or over-indebtedness. The same shall apply to the organ representatives of the partners authorized to represent the company or the liquidators in the case of a company without legal personality where none of the general partners is a natural person; this shall not apply if one of the general partners is another company in which a general partner is a natural person.

One of the main objectives of the German legislator was to be able to apply the aforementioned (from a formal point of view mainly) *corporate* law stipulations also to quasi-foreign (“letter box”-)companies, e.g., a UK Ltd. with its center of main interest in Germany. Before the enactment of the *MoMiG*, directors of such companies might not have been obliged to petition for insolvency under German law, since German company law was not applicable.⁶ Even though it is disputed amongst German scholars whether such incorporation of the respective provision(s) in the German Insolvency Code changes the *legal nature* of the stipulations from company law to insolvency law, this clearly shows that German law acknowledges a close gearing of insolvency and company law and thus provides for a close-meshed regime on company directors’ liability, including accompanying criminal law provisions.

The main features of the German regime of obligation to file for insolvency and connected provisions on liability for managing directors will be outlined in the following.

3 § 64 para. 1 GmbHG in the version until 31 October 2008.

4 § 92 Abs. 2 AktG in the version until 31 October 2008.

5 § 130a Abs. 1 HGB in the version until 31 October 2010; however, this only applies to general and limited partnerships where none of the general partners is a natural person.

6 See MoMiG rationale, Begr RegE, BT-Drucksache 16/6140, p. 55.

2 OBLIGATION OF A MANAGING DIRECTOR OF A GERMAN GMBH⁷ TO REQUEST FOR COMMENCEMENT OF INSOLVENCY PROCEEDINGS

2.1 *Basic Principles*

Pursuant to Section 15a para. 1 of the German InsO, any (registered) managing director (*Geschäftsführer*) of a corporation has an obligation to petition for the commencement of insolvency proceedings (*Insolvenzantragspflicht*) in the event the entity is illiquid or overindebted. A managing director cannot be released from this obligation, e.g., by directions to the contrary by the shareholder. Moreover, a managing director would become liable for damages toward the company and/or the shareholders if he carries out such a direction. In case the company is deemed insolvent, the managing directors are to file the petition without culpable delay and at the very latest within 3 weeks. This gives the managing directors a final opportunity to undertake serious attempts to remove the grounds for insolvency.⁸ An attempt to attain financial recovery must, therefore, be sufficiently successful within the 3-week period so that it is at least probable that the grounds for insolvency will be removed.⁹

The same applies to persons de facto acting as a managing director, in particular the so-called shadow directors (*faktischer Geschäftsführer*).¹⁰

2.2 *Mandatory Reasons for Insolvency under German Insolvency Law*

The German Insolvency Code names two grounds for insolvency, which pose the obligation on the managing director to petition for the initiation of insolvency proceedings as explained in the preceding section:

- illiquidity
- overindebtedness.

When one of these insolvency criteria has been established, formal insolvency proceedings must in general be initiated.

7 Unless stated otherwise, the following will refer to Limited Liability Companies, but is generally applicable to directors of other forms of corporations in Germany.

8 Cf. Bußhardt, *Braun Insolvenzordnung*, 7th ed., München, C.H. Beck, 2017, § 15a, m.n. 16.

9 Cf. Mönning, *Nerlich/Römermann Insolvenzordnung*, 33rd ed., München, C.H. Beck, 2017, § 15a, m.n. 16.

10 German Federal Supreme Court (*Bundesgerichtshof*, BGH), Order dated 18 December 2014, file no. 4 StR 323/14, 4 StR 324/14.

2.2.1 Illiquidity¹¹

A company is deemed to be illiquid (*zahlungsunfähig*) if it is unable to pay its debts as they fall due and is generally presumed to be illiquid when it has ceased to make payments.¹² In this respect, the German Federal Supreme Court (*Bundesgerichtshof*, BGH) has specified that if a debtor can reasonably expect to be able to pay those debts which are already due and those which will fall due within the next 3 weeks, he should not be considered to be illiquid.¹³ Furthermore, pursuant to the jurisprudence of the *Bundesgerichtshof* and slightly deriving from the definition under civil law, a claim is only deemed to be ‘due’ from a German insolvency law perspective if the creditor *seriously claims* the due payment (*ernsthafte Einfordern*),¹⁴ e.g., by initiating compulsory enforcement measures or appointing a collection agency. Therefore, any kind of ‘standstill’ with creditors might also postpone the maturity under German insolvency law.¹⁵

If the overall amount which the company is unable to pay constitutes less than 10% of the total payments falling due in that period, it will only be considered to be illiquid (1) if the shortfall is likely to increase to more than 10% in the near future or (2) in case the shortfall cannot be discharged in the near future.¹⁶ Conversely, if the liquidity shortfall amounts to 10% or more of the total amount due for payment, the company will be presumed to be illiquid, unless there is a strong likelihood that the shortfall can be met completely, or almost completely, and the creditors can reasonably be expected to wait.¹⁷ Accordingly, a mere temporary interruption in payments (*vorübergehende Zahlungsstockung*) does not constitute illiquidity.¹⁸

When determining liquidity, all liabilities that have fallen due for payment must be taken into account, but all deferred liabilities are ignored (see also above, *ernsthafte Einfordern*). Thus, in order to assess whether or not a German GmbH is illiquid in the meaning of Section 17 InsO, the managing director has to produce a cash-balance-sheet showing available liquidity on the one hand and due debts on the other. If then the due debts (less claims that are not seriously claimed) are covered by the available cash (including a credit line and including liquidity that can be collected within the following 3 weeks) by 90% or more, the GmbH is not considered illiquid. It is highly disputed, however, whether or not payables of the debtor that become due within the aforementioned 3-week period have to be taken into consideration.¹⁹

11 § 17 para. 1 InsO.

12 § 17 para. 2 InsO.

13 BGH, Judgment dated 24 May 2005, file no. IX ZR 123/04.

14 BGH, Order dated 19 July 2007, file no. IX ZB 36/07.

15 Cf. Schmidt, *Karsten Schmidt Insolvenzordnung*, 19th ed., München, C. H. Beck, 2016, § 17, m.n. 12,13.

16 BGH, Judgment dated 24 May 2005, file no. 123/04.

17 *Ibid.*

18 *Ibid.*

19 So-called “Bugwellentheorie”, Cf. Schmidt, *Karsten Schmidt Insolvenzordnung*, 19th ed., München, C.H. Beck, 2016, § 17, m.n. 27 foll.; Bork, ‘Zahlungsunfähigkeit, Zahlungsstockung und Passiva II’, *ZIP Zeitschrift für Wirtschaftsrecht*, 2008, pp. 1749 foll.; Ganter, ‘Die Bedeutung der “Bugwelle” für die Feststellung der

Both debtors and creditors are entitled to file for insolvency on grounds of illiquidity.²⁰ Moreover, only the managing directors of the debtor are obliged to do so without culpable delay and at the latest, 3 weeks after the occurrence of the insolvency event.

2.2.2 Overindebtedness, 'Überschuldung' (Section 19, InsO)

In general, a company is deemed to be overindebted if its assets are insufficient to meet its current liabilities. However, the definition of overindebtedness has been amended in the context of the financial market stabilization measures enacted in Germany in 2008.²¹ Thus, even in circumstances where liabilities exceed assets, a company will not be deemed to be overindebted if facts indicate that it is more likely than not that the business will be able to survive.

This may, for example, be the case if certain claims do not have to be taken into consideration when a so-called liquidation balance sheet is made up. Pursuant to German insolvency law, certain claims are subordinated by law²² and do therefore not have to be put into such a liquidation balance sheet and they would also not be enforceable in case of insolvency proceedings.²³ Additionally, debtor and creditor may enter into a subordination agreement, which states that the creditor's claims are subordinated with respect to all other creditors' claims in order to avoid an overindebtedness of the debtor.²⁴ Such contractual subordination is common with respect to shareholder loans that are subordinated by German statutory law, anyway.²⁵ Furthermore, a repayment of shareholder loans within 1 year prior to a request for insolvency could be clawed back by the insolvency administrator.²⁶

One measure used to support a positive continuation prognosis is a so-called (internal) hard letter of comfort (*interne harte Patronatserklärung*). Such letter of comfort would usually be issued by the shareholder of a company, stating that the shareholder will provide sufficient financial support, as the case may be limited to a certain amount, in order to assure that the company will be able to meet all of its financial obligations as they fall due, which would also indicate that an illiquidity of the company will be prevented. If a director receives such hard letter of comfort by its shareholder and has no reason to doubt that the shareholder will be able to provide such financial assistance if requested,

Zahlungsunfähigkeit', *ZInsO Zeitschrift für das gesamte Insolvenzrecht*, 2011, pp. 2297 foll.; BGH, Judgment dated 24 May 2005, file no. IX ZR 123/04.

20 §§13 para. 1 s. 2, 14 InsO.

21 See Financial Market Stabilisation Act (*Finanzmarktstabilisierungsgesetz*) of 17 October 2008.

22 § 39 para. 1 InsO.

23 Cf. Hirte, *Uhlenbruck Insolvenzordnung*, 14. ed., München, Franz Vahlen, 2015, § 39, m.n. 53.

24 Cf. BGH, Judgment dated 5 March 2015, file number IX ZR 133/14.

25 § 39 para. 1 No. 5 InsO.

26 § 135 para. 1 No. 2 InsO.

not only the claim against the shareholder may be activated in the company's balance sheet (and may thus already prevent an overindebtedness²⁷). He may also be confident that the continuation of the company's business is more likely than the discontinuation so that the ongoing prognosis would be positive. Ideally, such hard letter of comfort would already be combined with a (contractual) subordination of the potential repayment claim by the patron in case the patronized company indeed receives financial support in order to take such potential repayment claim out of the potential liquidation balance sheet as well.

Although the legal provisions provide flexibility when assessing whether or not the businesses of the GmbH will survive, the directors' positive outlook must be based on economically plausible accounting, cash flow and profit forecasts that will need to stand up to later scrutiny in court.²⁸

2.3 *Filing Period*

Managing directors are in general constantly expected to assess and assure the financial situation of the company, as the case may be with the support of an experienced insolvency advisor. This is particularly true when a ground of insolvency, as defined by German insolvency law, may threaten.²⁹ Directors are deemed to act negligent in this regard if they fail to do so.³⁰

As stated in Section II.1, any managing director is to file the petition without culpable delay, at the latest within 3 weeks. The 3-week period mentioned in the provision, however, does not constitute a deliberation period or a wait-and-see period.³¹ On the contrary, the *Insolvenzordnung* thus provides the managing directors with a last opportunity, limited to a period of 3 weeks, to undertake serious attempts to remove the grounds for insolvency (inability to pay debts or overindebtedness).

2.4 *Liability toward the Company / the Insolvency Administrator*

Pursuant to Section 64 sentence 1 of the German Limited Liability Companies Act, each managing director of a GmbH is personally liable toward the company for payments he

27 Cf. Mock, *Uhlenbruck Insolvenzordnung*, 14th ed., München, Franz Vahlen, 2015, § 19, m.n. 108 foll.

28 BGH, Judgment dated 14 May 2007, file no. II ZR 48/06; BGH, Judgment dated 27 March 2012, file no. II ZR 171/10.

29 BGH, Judgment dated 14 May 2007, file no. II ZR 48/06; BGH, Judgment dated 27 March 2012, file no. II ZR 171/10; BGH, Judgment dated 19 June 2012, file no. II ZR 243/11.

30 BGH, Judgment dated 27 March 2012, file no. II ZR 171/10; BGH, Judgment dated 2 February 1995, file no. II ZR 9/94.

31 Cf. Schmidt/Herchen, *Karsten Schmidt Insolvenzordnung*, 19th ed., München, C. H. Beck, 2016, § 15a, m.n. 31.

made to third persons after the company became insolvent or after the overindebtedness of the company was discovered. The rule, which may be seen as a crucial part of the remedies German law provides for wrongful trading of managing directors,³² stipulates the obligation of the director to reimburse payments he made to third-party creditors after the company was deemed to be insolvent. Such claim would be asserted by the insolvency administrator (*Insolvenzverwalter*) after commencement of insolvency proceedings, Section 92 InsO. There is an exception from this liability for cases in which the managing director acted consistently with the due care of a prudent businessman, even after duty to initiate insolvency proceedings has arisen.³³ This may be the case, for example, when payments to the tax authorities or social security agencies are made.

Pursuant to Section 64 sentence 3 GmbHG, the same obligation shall affect the managing directors regarding payments to shareholders if these led to the company becoming illiquid, unless this was not recognizable while observing the due diligence of a prudent businessman. However, the managing director has the duty to prove the necessity to make the payment.

Outside the vicinity of insolvency, managing directors are in general held to conduct the company's affairs with the due care of a prudent businessman and would be liable toward the company for a breach of such duties pursuant to Section 43 GmbHG.

2.5 Liability toward Third Parties

Furthermore, a managing director who does not file a petition to commence insolvency proceedings, or files it too late, is liable toward the company's creditors. In this case it will be differentiated between creditors who had a claim against the company already before the duty to file for insolvency arose (old creditors, *Altschuldner*) and those who first entered into a business relationship with the company afterwards (new creditors, *Neuschuldner*). Case law now recognizes that 'old creditors' only have a claim for damages insofar as the smaller dividend resulting from the belated petition for insolvency proceedings covers the claim (*Quotenschaden*).³⁴ New creditors, however, may assert claims for full damages against the managing director.³⁵ Whereas the '*Quotenschaden*' must be asserted by the insolvency administrator,³⁶ the new creditor raises a direct damage claim against the managing director.³⁷

32 BGH, Judgment dated 5 May 2008, file no. II ZR 38/07; BGH, Order dated 10 April 2003, file no. IX ZB 586/02; BGH, Judgment dated 8 January 2001, file no. II ZR 88/99.

33 § 64 sentence 2 GmbHG.

34 BGH, Judgment dated 6 June 1994, file no. II ZR 292, 91.

35 BGH, Judgment dated 6 June 1994, file no. II ZR 292, 91; BGH, Judgment dated 5 February 2007, file no. II ZR 234/05.

36 § 92 InsO.

37 BGH, Judgment dated 6 June 1994, file no. II ZR 292, 91.

Furthermore, each managing director who does not file a petition to commence insolvency proceedings or files it too late is liable toward the company's creditors for damages caused by the late filing pursuant to Section 823 para. 2 of the German Civil Code (*Bürgerliches Gesetzbuch*, BGB) in conjunction with Section 15a InsO. Moreover, a managing director who does not file a petition for initiation of insolvency proceedings or does so too late may also have a criminal liability due to 'delay of insolvency' (*Insolvenzverschleppung*).³⁸

In addition, a managing director would also be personally liable toward social insurance agencies in case the company (as employer) withholds contributions of an employee to the social security system, *i.e.*, because the company is unable to pay the due contributions, pursuant to Section 823 para. 2 BGB in conjunction with Section 266a of the German Criminal Code (*Strafgesetzbuch*, StGB). This would also impose a criminal liability,³⁹ which is only eligible for the social security contributions of the employees.⁴⁰

Finally, Section 69 of the German Fiscal Code (*Abgabenordnung*, AO) stipulates a personal liability of the managing director as representative of the company toward the tax authority, where due tax-claims, *e.g.*, VAT, are not satisfied due to a breach of the duties imposed on him.

2.6 Criminal Liability

As already mentioned, besides a possible obligation to pay damages under civil law, the managing director who does not file a petition for initiation of insolvency proceedings or does so too late also faces a criminal liability due to 'delay of insolvency' (*Insolvenzverschleppung*), pursuant to Section 15a para. 4 InsO, which stipulates:

Whoever [...] does not file a request for the opening of proceedings, does not correctly file a request or does not file a request in good time shall be punished with imprisonment for not more than three years or a fine.

It has to be noted that also those may be punished who merely negligently (*fahrlässig*) did not (or did, but too late) file a request for insolvency. This would for example be the case if a managing director, due to the internal division of business areas, negligently noticed too late that the company was in an economic crisis.⁴¹ In practice, it is rather difficult to reach exoneration from the reproach of negligence.

38 See Section II.6.

39 See Section II.6.

40 See Jenal, *Beck/Depré, Praxis der Insolvenz*, 3th ed., München, Franz Vahlen, 2017, § 33, m.n. 39.

41 BGH, Judgment dated 1 March 1993, file. no. II ZR 61/92.

Finally, a managing director is also facing criminal liability if the company withholds contributions of an employee to the social insurance agency pursuant to Section 266a StGB.

It has to be noted that every insolvency procedure automatically leads to criminal investigations against the registered managing directors that more often than not lead to a punishment of the directors.

3 SPECIFIC QUESTIONS

3.1 *To what extent do directors run special risks in the context of a restructuring when they enter into new obligations, including new secured financing?*

- a. As explained in Sections II.1 and II.3, directors are obliged to request the commencement of insolvency proceedings if a ground for insolvency occurs and cannot be overcome within a maximum period of 3 weeks. If directors seek new financing in order to solve a financial crisis of the company, an important distinction has to be made, *i.e.*, whether a ground for insolvency that leads to the obligation to file for insolvency is already met.

In this context it has to be mentioned that the German Insolvency Code provides for a third ground for insolvency, *i.e.*, imminent illiquidity,⁴² which, however, does not trigger the managers' mandatory duty to request commencement of insolvency proceedings pursuant to Section 15a InsO. A company will be deemed to be imminently illiquid, if it is highly probable that at some point in the future, it will be unable to pay its debts as they fall due. When it appears that the company is more likely to become illiquid than to recover, it is deemed to be imminently illiquid. In cases where the management decides not to file for insolvency, it must closely monitor the company's financial situation on a 'worst case' basis, as the management is obliged to file for insolvency without culpable delay if the perceived imminent illiquidity turns into, or is, in fact, an actual illiquidity.

If the company is already deemed illiquid or overindebted, *i.e.*, the directors are already within the 3-week period, any attempt to attain financial recovery must therefore be sufficiently successful within the 3-week period so that it is likely that the grounds for insolvency will be removed.⁴³ Thus, the managing directors have to assess whether the company will be able to fulfil its (contractual) obligations respectively in case of new financing. It is crucial that the directors may be confident that the new

42 § 18 InsO.

43 See Section II.1.

financing will be sufficient to overcome the current financial crisis of the company and not only prolong the financial struggle.⁴⁴

- b. In case the directors enter into new obligations within the filing period, *i.e.*, after an obligatory reason for insolvency occurred, a multitude of liability risks exists (see also above). With respect to the company itself, directors may be held liable pursuant to Section 64 sentence 1 GmbH for any payments made after the company has become illiquid or after it is deemed to be overindebted, unless such payments are compatible with the due care of a prudent businessman, *i.e.*, necessary to either maintain the business (*betriebsnotwendig*) or to avoid personal liability, *e.g.*, payments on taxes and social contributions.

If the directors thus file too late for the commencement of insolvency proceedings, they may further be liable toward third-party creditors pursuant to Section 823 para. 2 BGB in conjunction with Section 15a InsO.⁴⁵

Additionally, there exists the risk of criminal liability for different reasons (for details, see also Section II.6). Furthermore, if the company has become illiquid or overindebted, any director who disposes of assets, which would belong to the insolvency estate might be held criminally liable pursuant to Section 283 of the German Criminal Code (*StGB*). This may in particular be true with respect to providing securities from the debtor's assets if a (new) financing were not sufficient to overcome the financial crisis.⁴⁶ If the company is not able to meet its contractual obligations, *e.g.*, payments for delivered goods or services, a director may also be held liable for fraud pursuant to Section 263 StGB if he was aware of the potential financial damage of the other party.

- c. Finally, a civil law liability might be applicable pursuant to Section 826 BGB, which basically sanctions damages, which are intentionally inflicted in a manner contrary to public policy. A special case in which such liability would apply is the so-called "intervention destroying the economic basis of the company" (*existenzvernichtender Eingriff*), which was ruled by the German Federal Court in a series of judgments, starting in 2001.⁴⁷ This legal practice somehow pierces the corporate veil by holding director and/or shareholder of the GmbH (personally) liable for liabilities of the company toward third-party creditors, if the director and/or shareholder intentionally extracts the company's assets.

Providing new securities may, therefore, also destroy the economic basis of the company.⁴⁸ This may particularly be true with respect to upstream securities toward the

44 BGH, Judgment dated 21 January 2016, file no. II ZR 84/13; BGH, Judgment dated 21. February 2013, file no. II ZR 52/10.

45 See Section II.5.

46 Cf. Kindhäuser, *Kindhäuser/Neumann/Paeffgen Strafgesetzbuch*, 5th ed., Baden-Baden, Nomos, 2017, § 283, m.n. 21, 23; cf. Fischer, *Thomas Fischer Strafgesetzbuch*, 64th ed., München, C. H. Beck, 2017, § 283, m.n. 4.

47 BGH, Judgment dated 17 September 2001, file no. II ZR 178/99.

48 Cf. Altmeppen, *Roth/Altmeppen GmbHG*, 8th ed., München, C. H. Beck, 2015, § 13 m.n. 83; Wilhelm, *Ziemons/Jaeger GmbHG*, 32. ed., München, C.H. Beck, 2017, § 13 m.n. 91.

company's shareholder as this might also offend the statutory German rules on capital maintenance.⁴⁹

- 3.2 *To what extent do directors run special risks in the context of restructuring when they engage in 'selective payment' (i.e., they decide to pay certain creditors while leaving other creditors unpaid)?*
- a. Selective payments in the vicinity of insolvency may constitute a liability with respect to wrongful trading under German law.⁵⁰ With respect to the company itself, a director may be held liable for any payments he made to third parties after the company became insolvent pursuant to German law, unless such payments are compatible with the due care of a prudent businessman as stated in Section III.1.b). However, the burden of proof of the necessity of such payments lies with the director. This leads to the conclusion that certain selective payments may be privileged and do not lead to a personal liability if (a) such payments are in line with the duties of a prudent businessman and were necessary for the continuation of the business during the crisis and (b) the managing director obeys the obligation to file for insolvency within the 3-week period of Section 15a InsO.
 - b. It should be mentioned that such payments to third-party creditors might also be subject to insolvency avoidance claims of a later insolvency administrator, *i.e.*, he might claw back such payments from the creditors. Such claim would require that the selective payment to a special creditor disadvantages the other creditors,⁵¹ which is basically the case if the potential insolvency estate is decreased or shortened respectively the selective payments would narrow a potential later distribution payment. This may not be the case if such payment was necessary to maintain the debtor's business so that a certain value was added to the estate in return,⁵² *e.g.*, payment for commodities that are processed so that a more valuable good could be sold by the debtor. In case a disadvantage of the other creditors cannot be ruled out, such payment may in particular be challengeable by the insolvency administrator, if the third-party creditor had knowledge of the tense financial situation of the debtor and was further aware or could have been aware that he was preferably paid.⁵³ If, therefore, the insolvency administrator has successfully clawed back payments from a creditor, the director will not be held liable for the same payment.
 - c. Again, the director may also be liable toward third-party creditors, if the selective payment lead to a culpable delay in requesting the commencement of insolvency

49 §§ 30, 31 GmbHG.

50 See Sections II.4 and II.5.

51 § 129 InsO.

52 OLG Saarbrücken, Judgment dated 23 January 2007, file no. 4 U 311/06.

53 § 133 InsO.

proceedings pursuant to Section 823 para. 2 BGB in conjunction with Section 15a InsO.⁵⁴

3.3 *To what extent:*

1. Does a general duty exist for directors to file for insolvency proceedings under certain circumstances (e.g., balance sheet insolvency, inability to pay)?

Pursuant to Section 15a InsO, directors are obliged to request the commencement of insolvency proceedings at the latest 3 weeks after the company has become illiquid or overindebted.⁵⁵

2. Do exceptions to the general duty as mentioned in item (a) exist?

There is no exception under German law from the aforementioned rule, as the directors have to file for insolvency if the legal grounds are met. However, Section 15a InsO does not apply in case the company is not yet illiquid but merely imminently illiquid.⁵⁶ Further, the obligation to request the commencement of insolvency proceedings may be overcome during the 3-week period, if the directors are successful in solving the mandatory insolvency reason.

3. Do the rules addressed in items (a) and (b) have a restricting effect in practice?

From a German law perspective, the 'official' answer to that question should be a clear YES. One of the legislators' main intentions in connection with the obligation to request the commencement of insolvency proceedings was to provide a pressure on directors to file for insolvency at an early stage.⁵⁷

This was further facilitated by the coming into effect of the Law for the further Facilitation of the Restructuring of Enterprises (*Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen*, ESUG) in 2009, which offers improved instruments in self-administration proceedings⁵⁸ in case the debtor's directors already file for insolvency if the company is only imminently illiquid.⁵⁹

However, in practice there may still be room for improvement, as many directors still file for insolvency too late and thus have to deal with personal and criminal liability issues afterwards. This might be slightly surprising because managing directors are instructed on their legal duties as managing directors of a corporation, inter alia on the obligation to request the commencement of insolvency proceedings if the com-

54 See Section II.5.

55 See Sections II.1-3.

56 See Section III.1 item (a).

57 See MoMiG rationale, Begr RegE, BT-Drucks. 16/6140, p. 55.

58 §§ 270 foll. InsO.

59 In particular in this case the debtor may enter into a so-called umbrella proceedings (*Schutzschirmverfahren*), which would enable the debtor to prepare a (prepackaged) insolvency plan. However, the criteria under which German insolvency courts order such umbrella proceedings are rather strict.

pany is deemed insolvent under German law, during the application to register the appointed director to the German commercial register.⁶⁰

As a rule of thumb, one could say that on the one hand directors who are well-advised by an insolvency law expert generally file for insolvency in due time and may prevent personal liability issues. This is often the case of larger companies. However, on the other hand, directors of small and medium-sized entities tend to seek legal advice too late or not at all. This may 'backfire' by way of personal liability after insolvency proceedings have been opened, albeit because of an insolvency application by a creditor (such as tax authorities and social security bodies).

Since the consequences of a personal liability are quite severe, directors of German companies may only be warned to seek insolvency advice as soon as possible in order to prevent any liability.

4. Does a prohibition on 'wrongful trading' exist and what are the consequences if a business is continued too long?

Under German law the principle of wrongful trading is known and thus a prohibition on wrongful trading exists, even though it is neither named 'wrongful trading' as in the UK nor stipulated in only one provision. Moreover, the prohibition of wrongful trading is formed by a mesh of different rules, which lead to personal liability for the directors from different angles.

In particular, this is formed by Section 64 sentence 1 GmbHG and Section 823 para. 2 BGB in conjunction with Section 15a para. 4 InsO. As already outlined, the consequence will be a personal liability of the directors for any damages caused toward the company and third-party creditors.

5. Are directors (jointly and/or severally) liable for the payment by the company of its tax and social security obligations?

Managing directors are held personally liable with respect to payment of the company's taxes and social security obligations if certain prerequisites are met.⁶¹ With respect to taxes, they are jointly and severally liable pursuant to Sections 69, 34, 44 AO for unpaid taxes if the managing directors were acting deliberately or grossly negligently. As far as payment of social contributions of an employee is concerned, a joint liability pursuant to Sections 823 para. 2 and 830 BGB in conjunction with Section 266a para. 1 StGB exists.

⁶⁰ § 39 GmbHG.

⁶¹ See Section II.5.

4 ARTICLE 18 OF THE PROPOSED DIRECTIVE ON PREVENTIVE RESTRUCTURING FRAMEWORKS⁶²

Article 18 of the Proposal contains an obligation for the member states to impose specific duties on directors in the vicinity of insolvency which would incentivize directors to pursue early restructuring when the business is still viable. Even though the wording of this article and a possible improvement is subject to discussions between European insolvency experts, from a German law perspective it does not seem to turn out that badly and need much improvement. This is in particular true because all issues addressed in Article 18 are already to a huge extent incorporated in and reflected by German company, respectively, the insolvency law. The details are as follows.

1. Directors shall take immediate steps to minimize the loss for creditors, employees, shareholders and other stakeholders. Given the obligation for managing directors to file for insolvency, this is already a basic principle of German insolvency law and is also reflected by the main objective of the German Insolvency Code as set out in Section 1 InsO, which reads: “The insolvency proceedings shall serve the purpose of collective satisfaction of a debtor’s creditors.”
2. Further, the guideline that directors shall have due regard to the interests of creditors and other stakeholders is also already in the best interest of German directors given the potential personal liability toward such creditors.
3. Directors shall also take reasonable steps to avoid insolvency. Even though this is not directly addressed under German law yet, this idea may to some extent be taken out of the existing German legal system. As directors have to closely monitor, assess and assure the financial situation of the company at all times and are obliged to file for insolvency if the legal criteria are met, it is again in their best interest to take such steps to prevent an insolvency at an early stage or otherwise to file for insolvency.
4. Finally, the Proposal states that directors shall be held to avoid deliberate or grossly negligent conduct that threatens the viability of the business. Given the German law system of personal liability of directors, in particular also the criminal liability and the liability concerning intervention destroying the economic basis of the company, this requirement should to a large extent already be inherent to German law provisions and would not necessarily require additional improvement.

62 Proposal of 22 November 2016 (2016/0359 (COD)) for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30 EU.

AN ENGLISH LAW PERSPECTIVE ON DIRECTORS' LIABILITY IN THE ZONE OF INSOLVENCY

NVR II REPORT

*Peter J.M. Declercq**

1 INTRODUCTION

Prior to 1 October 2007, the duties of directors of a company were derived from common law, equitable principles and some statutory provisions in the Companies Act 1985. However, since the enactment of the Companies Act 2006 (CA 2006) the general fiduciary duties of a director are predominantly set out therein. As the stated intention of the codification was principally to restate rather than change the law, the corresponding common law and equitable principles will remain relevant when interpreting and applying the general duties.¹ The consequences of breach will be the same as they would have been for breach of the previous corresponding duties, as there has been no codification of the remedies for breach of the general duties.²

1.1 *Directors' Duties*

The codified directors' duties are:³

1. Duty to act within powers;⁴

* Partner at DCQ Legal Ltd. The author would like to thank Hannah Brellisford for her contributions to this report.

1 See S. Mortimore QC (ed.), *Company Directors, Duties, Liabilities and Remedies*, 3rd edition, 2017, Chapter 10 (General Duties of Directors) by M. Arnold QC, at 10.03 and 10.04.

2 Section 178 CA 2006.

3 Certain duties that are not explicitly codified include: (i) the duty to consider the interests of creditors when the company is insolvent or facing the threat of insolvency (general reference to this duty is made in Section 172(3) CA 2006); (ii) the duty not to defraud the company (although this will in practice overlap with the duty to act within the powers and the duty to promote the success of the company); (iii) the principle that the directors are to be regarded as trustees of property belonging to the company which is in their hands or under their control and the related duties to account for and not to misapply such property; and (iv) the duty of a director to disclose his/her own misconduct (although this will usually arise in the context of his duty to promote the interests and success of the company). See Mortimore, *supra* note 2, at 10.05.

4 Section 171 CA 2006.

2. Duty to promote the success of the company;⁵
3. Duty to exercise independent judgment;⁶
4. Duty to exercise reasonable care, skill and diligence;⁷
5. Duty to avoid conflicts of interest;⁸
6. Duty not to accept benefits from third parties;⁹ and
7. Duty to declare any interest in a proposed transaction or arrangement.¹⁰

It is further specifically codified¹¹ that the duty to promote the success of the company has effect subject to any enactment or rule of law requiring directors, under certain circumstances, to consider or act in the interest of the creditors of the company. This is a reference to the common law rule that, once a company becomes insolvent or nears insolvency (*i.e.*, enters the zone of insolvency), the interests of the creditors are paramount over those of the members (*i.e.*, shareholders) of the company.¹² From that point onwards, the focus of the directors' duties changes: they are now subject to an overriding duty to have regard to the interests of the general creditors of the company.¹³

In English law, directors' duties are owed to the company and therefore enforceable by the company.¹⁴ The CA 2006 contains a number of provisions regarding the protection of directors from liability.¹⁵ With certain exceptions,¹⁶ any provision by which a company directly or indirectly provides an indemnity (to any extent) for a director of the company,

5 Section 172 CA 2006.

6 Section 173 CA 2006.

7 Section 174 CA 2006.

8 Section 175 CA 2006.

9 Section 176 CA 2006.

10 Section 177 CA 2006.

11 Section 172(3) CA 2006.

12 See, e.g., *Re Idessa (UK) Ltd (in liquidation) (Burke v. Morrison)* [2011] EWHC 804 (Ch).

13 As will be addressed in more detail in Section 1.2 of this report, when exactly the directors' duties change will need to be determined on a case by case basis. In *BTI 2014 LLC v. Sequana SA* [2016] EWHC 1686 (Ch) at para. 479 it was held that directors cannot be required to run the company in the interests of creditors on the basis only of a remote risk of insolvency because a risk exists that best estimate might turn out to be incorrect. If a company has on its balance sheet a provision in respect of a long term liability (e.g., an environmental clean-up liability) but there is a risk that the provision made may be inadequate, to put creditors' interests ahead of shareholders' for this extended period would be a significant inroad into the normal application of directors' duties. In *Dickinson v. NAL Realisations (Staffordshire) Ltd* [2017] EWHC 28 (Ch) it was further held that just because there is a recognized risk of adverse events that would lead to insolvency (for example an environmental claim being lost and leading to insolvency of the company), this does not necessarily mean that the interests of creditors should automatically come before those of its members.

14 See P. Loose, M. Griffiths and D. Impey, *The Company Director: Powers, Duties and Liabilities*, 12th edition, 2015, Chapter 7 (Liabilities of Directors) at 7.145.

15 Sections 232-238 CA 2006.

16 Exceptions are: (a) Section 233 CA 2006 (provision of insurance), (b) Section 234 CA 2006 (qualifying third party indemnity provision), or (c) Section 235 CA 2006 (qualifying pension scheme indemnity provision).

or of an associated company,¹⁷ against any liability attaching to him/her in connection with any negligence, default, breach of duty or breach of trust in relation to the company of which he/she is a director is void (whether the provision is contained in a company's articles or in any contract with the company or otherwise).¹⁸ However, this does not prevent a company from purchasing and maintaining for a director of the company, or of an associated company, insurance against any such liability.¹⁹ It is further possible, outside of the zone of insolvency,²⁰ for the company to decide to ratify conduct by a director amounting to negligence, default, breach of duty or breach of trust in relation to the company by resolution of the members of the company.²¹

1.2 *The Zone of Insolvency*

So when does a company enter the zone of insolvency? Case law provides the following guidance:

- a. Where the company is “doubtfully solvent”;²²
- b. Where the company is in a “very dangerous” or “parlous” financial state;²³
- c. Where the company is in a “dangerous” or “precarious” financial position;²⁴
- d. Where the company is in a state of “doubtful solvency or on the verge of insolvency”;²⁵ and
- e. Where “there is a real and not remote risk of insolvency”.²⁶

With the above rather imprecise guidance, it will have to be determined on a case-by-case basis when a duty to consider the interests of creditors arises. The Court will focus on the degree of risk of insolvency and of prejudice to creditors, in consequence: the duty will arise where there is a real and not remote risk that the creditors' expectations and entitlement to be paid will be prejudiced if the directors cause the company to make a certain decision or embark on a certain course of action.²⁷

The Insolvency Act 1986 (IA 86) provides further guidance on when a company is deemed to be “unable to pay its debts.” Section 123 IA 86 sets out a number of situations

17 Associated company means a company in the same group as the company of which the director is a director. (See also, Section 256 CA 2006).

18 Section 232 CA 2006.

19 Section 233 CA 2006.

20 Loose *et al.*, *supra* note 15, at para. 7.139.

21 Section 239 CA 2006.

22 *Brady v. Brady* [1988] BCLC 20, at p. 40.

23 *Facia Footwear Ltd v. Hinchcliffe* [1998] 1 BCLC 218, at p. 228.

24 *Re MDA Investment Management Ltd*, [2004] 1 BCLC 217, at p. 75.

25 *Colin Gwyer & Associates Ltd v. London Wharf (Limehouse) Ltd* [2002] EWHC 2748.

26 *BTI 2014 LLC v. Sequana SA and others* [2016] EWHC 1686.

27 See Mortimore, *supra* note 2, Chapter 12 (Duty to promote the success of the company), by M. Arnold QC and M. Haywood, at 12.86 and 12.90.

in which a company is deemed to be unable to pay its debts. This inability to pay debts can be met based on a cash-flow basis (*i.e.*, where the Court is satisfied that the company is unable to pay its debts as they fall due [for example, if a so-called ‘statutory demand’²⁸ has been made and not complied with by the company])²⁹ or a balance sheet basis (*i.e.*, where a Court is satisfied that the value of the company’s assets is less than its liabilities [taking into account its contingent and prospective liabilities]).³⁰ Both tests contain a ‘futurity requirement’ and in the cash-flow (or commercial insolvency) test this is captured in the words “as they fall due.”³¹ This means that also debts falling due from time to time in the reasonably near future need to be considered. What the reasonably near future is, for this purpose, will depend on the circumstances, but especially the nature of the company’s business.³²

The zone of insolvency period for directors can be said to terminate when formal insolvency proceedings are commenced as the directors’ powers to bind the company either cease or are suspended as against the incoming administrator or liquidator.

2 WRONGFUL TRADING

The 1986 insolvency legislation introduced a ‘fault’-based liability for wrongful trading.³³ Before that, the main risk of personal liability for company’s debts was the law of fraudulent trading (see Section 3(a) of this report) under which a director was unlikely to be liable as long as he was honest, even if hopelessly misguided in his/her beliefs.³⁴ The defense of acting honestly and reasonably³⁵ does not apply to claims for wrongful trading.³⁶

28 Section 123(1)(a)/IA 86 describes a ‘statutory demand’ as a demand made in writing by a creditor for a debtor to pay a sum i//n excess of £750, which remains unpaid for 21 days.

29 Section 123(1) IA 86.

30 Section 123(2) IA 86.

31 *Re Cheyne Finance Plc* [2008] 2 All ER 987 at pp. 53-56 and 70.

32 *BNY Corporate Trustee Services Ltd and others v. Eurosail-UK 2007-3BL plc* [2013] UKSC 28, at 37. While examples used in *Re Cheyne Finance*, *supra* note 32, at pp. 55 and 65 consider debt that falls due in 6 months, the specific circumstances of each case will have to be considered to determine what in that case qualifies as ‘the reasonably near future’. Once the Court has to move beyond the reasonably near future, a comparison of present assets with present and future liabilities (discounted for contingencies and deferment) becomes the only sensible test.

33 Section 214 IA 86. For wrongful trading in administration, *see* Section 246ZB IA 86.

34 Following the introduction of wrongful trading, recourse based on fraudulent trading has become relatively rare since all cases of fraudulent trading by a director are likely to fall within wrongful trading as well. *See* Mortimore, *supra* note 2, Chapter 34 (Directors’ Liabilities in Insolvency Proceedings) by C. Cooke, at 34.31. However, *see also* Hamish Anderson, *The Framework of Corporate Insolvency Law*, 2017, at 17.20 and 17.21 where he highlights that the remedies of fraudulent trading and wrongful trading are fundamentally different and therefore, following the introduction of wrongful trading, the concept of fraudulent trading has in his view not become redundant. Furthermore, the scope of fraudulent trading is wider than that of wrongful trading, which is limited to (shadow) directors only.

35 Section 1157 CA 2006.

36 *See* Mortimore, *supra* note 2, at 34.69. *See also* Hamish Anderson, *supra* note 35, at 17.16. Instead of having to prove dishonesty (as is the case for fraudulent trading), there is a tortious standard of care for wrongful trading.

2.1 Elements for a Wrongful Trading Claim

For liability under wrongful trading to occur, the following elements must be met:

- a. It applies to directors³⁷ or shadow directors³⁸ of the company;³⁹
- b. The company has at some point gone into insolvent liquidation or insolvent administration (*i.e.*, creditors go at least in part unpaid);⁴⁰
- c. At some point in time prior to the commencement of insolvency proceedings, the (shadow) director knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation or insolvent administration (the 'no reasonable prospect requirement');⁴¹ and
- d. If the 'no reasonable prospect requirement' is met, liability can still be avoided by a (shadow) director if from that point in time onwards the (shadow) director took every step with a view to minimizing the potential loss to the company's creditors as he ought to have taken (the 'every step defense').⁴²

2.2 Objective and Subjective Standards

For both the no reasonable prospect requirement and the every step defense, the law imposes an objective as well as a subjective standard.⁴³ The objective standard assumes a reasonably diligent person having the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by

37 Section 251 IA 86 clarifies that the term 'director' includes "any person occupying the position of director, by whatever name called." This mirrors the description of 'director' in Section 250 CA 2006. The word 'director' embraces any person who, while described as a manager, governor or principal, is actually directing the business of his/her company. A person who has been formally appointed and who has ticked all the boxes as required by the CA 2006 is generally referred to as a *de jure* director. A person who acts as a director, but without having been formally appointed is referred to as a *de facto* director. (Loose *et al.*, *supra* note 15, Chapter 7 (Liabilities of Directors) at paras. 7.9 and 7.10).

38 Section 251 IA 86 defines a 'shadow director' as "a person in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on the advice given by him in a professional capacity)." This mirrors the description of 'shadow director' in Section 251 CA 2006. So to prove that a person is a shadow director it has to be established (i) who actually are the directors of the company (*de facto* or *de jure*), (ii) that the person alleged to be the shadow director directed those persons to act in relation to the company or that he was one of the persons who did so, (iii) that those directors acted in accordance with such directions, and (iv) that they were accustomed so to act (Loose *et al.*, *supra* note 15, at 7.14). Before outsiders such as banks qualify as 'shadow director' a considerable degree of interference is probably necessary. Dictating corporate strategy or requiring the cessation or commencement of a line of business might be enough. (Loose *et al.*, *supra* note 15, at 7.101).

39 Section 214(2)(c) IA 86/Section 246ZB(2)(c) IA 86.

40 Section 214(2)(a) IA 86/Section 246ZB(2)(a) IA 86.

41 Section 214(2)(b) IA 86/Section 246ZB(2)(b) IA 86.

42 Section 214(3) IA 86/Section 246ZB(3) IA 86.

43 Section 214(4) IA 86/Section 246ZB(4) IA 86.

that director in relation to the company (the 'objective standard').⁴⁴ The subjective standard assumes a reasonably diligent person having the general knowledge, skill and experience that that director has (the 'subjective standard').⁴⁵

2.3 *No Reasonable Prospect Requirement*

The no reasonable prospect requirement depends upon rational expectations as to the future, but directors are not clairvoyant and the fact that they fail to see what eventually comes to pass does not mean that they are guilty of wrongful trading.⁴⁶ However, such rational expectations do not exist where there has been 'confusion between aspiration and actuality',⁴⁷ 'willfully blind optimism',⁴⁸ 'reckless belief',⁴⁹ and unreasonable hope that 'everything would turn up'.⁵⁰ If a director, for example, expected that his/her codirector would fulfill various contracts to which the company had been committed by that codirector, appropriate evidence must be submitted to the Court that arrangements had been entered into with the counterparty of those contracts in order to fulfill them. In the absence of any such evidence, the Court will have to conclude that the expectation was not a reasonable one.⁵¹ If a company is both balance sheet and cash-flow insolvent and unable to meet the conditions imposed by its bank for additional funding necessary in order to be able to employ a building contractor to develop its only piece of land, no prospect of entering into a fixed price contract with the contractor exists. If, in addition, talks with a prospective coinvestor had collapsed and there had been no presales of units on the site, directors will be held liable for wrongful trading if they continue trading under such circumstances.⁵²

In the zone of insolvency, it is important that a director expressly raises the question of whether the company can properly continue to trade. This question must be considered directly, closely and frequently, and cannot be ignored.⁵³

44 Section 214 (4)(a) IA 86/Section 246ZB(4)(a) IA 86.

45 Section 214(4)(b) IA 86/Section 246ZB(4)(b) IA 86.

46 *In the matter of Ralls Builders Limited (in liquidation)* [2016] EWHR 243 (Ch) at 172.

47 *Roberts v. Frohlich* [2011] EWHC 257 (Ch).

48 *Langreen Ltd (in Liquidation)* [2011] LTL 26/10/2011.

49 *Roberts v. Frohlich*, *supra* note 48.

50 *Singla v. Hedman* [2010] EWHC 902 (Ch).

51 *Re Kudos Business Systems* [2011] EWHC 1436.

52 *Roberts v. Frohlich*, *supra* note 48, at pp. 111-112. Norris J. concluded that "(...) the hope that 'something might turn up' was on an objective view groundless and forlorn. Insolvent liquidation was all but inevitable."

53 *Continental Assurance Co of London Plc* [2001] BRIP 733, at paragraph 107.

2.4 Every Step Defense

In the context of the every step defense, the following guidance was given by the Court in respect of the kind of steps a director should take:⁵⁴

ensuring accounting records are kept up to date with a budget and cash flow forecast, preparing a business review and a plan dealing with future trading including steps that can be taken (for example cost cutting) to minimise loss; keeping creditors informed and reaching agreements to deal with debt and supply where possible; regularly monitoring the trading and financial position together with the business plan both informally and at board meetings; asking if loss is being minimised; ensuring adequate capitalisation; obtaining professional advice (legal and financial); and considering alternative insolvency remedies.

The every step defense is intended to be a high hurdle for directors to surmount and therefore, for the every step defense to be successful, a director must show that (i) continued trading was intended to reduce the net deficiency of the company and (ii) the continued trading was designed appropriately to minimize the risk of loss to individual creditors and not simply that the continued trading reduced the overall loss to the general body of creditors irrespective of how the result was achieved between creditors.⁵⁵ Losses that would have been incurred in any event as a consequence of a company going into a formal insolvency proceeding, are not to be considered in this context.⁵⁶ If the director can show that he took 'every step' with a view to minimizing the potential loss to creditors, he avoids liability even if he/she does not actually succeed in his/her objective.⁵⁷

In this context it should be noted that resignation is unlikely to afford a director any defense. Once he/she ought to have concluded that the no reasonable prospect requirement was met, he/she is *prima facie* liable whether or not he/she remains on the board.⁵⁸ The every step defense requires the director to look to the interests of existing and potential creditors, which reinforces the conclusion that resignation from the board will rarely be sufficient, or advisable.⁵⁹

54 *Robin Hood Centre plc* [2015] EWHC 2289 (Ch) at 259.

55 *Ralls Builders Limited*, *supra* note 47, at p. 245.

56 *Ibid.*, at p. 242.

57 *Ibid.*, at p. 244.

58 *Loose et al.*, *supra* note 15, at 7.91. See regarding resignation also United Nations Commission on International Trade Law, *UNCITRAL Legislative Guide – Part four: Directors' Obligations in the Period Approaching Insolvency*, 2013, Chapter II (Elements of directors' obligations in the period approaching insolvency), at para. 27.

59 *Loose et al.*, *supra* note 15, at 7.93.

2.5 Contribution

For a Court to order a director to make a contribution payment because of wrongful trading liability, there must be evidence that the company's position was made worse as a result of the, wrongful, continued trading.⁶⁰ The starting point is therefore that there must be an increase in the net deficiency of the company, which reflects the loss to the company itself as a result of liquidation being delayed.⁶¹ The Court is granted a discretionary jurisdiction to declare that a director is liable to make a contribution (if any) to the company's assets as the Court thinks proper.⁶² This jurisdiction is primarily compensatory rather than penal.⁶³ The contribution to the assets that the company's creditors will share in the liquidation should reflect (and compensate for) the loss that has been caused to creditors by carrying on the business in the manner that amounted to wrongful trading.⁶⁴

2.6 Rescue Culture

The companies' legislation in the UK does not impose on directors a statutory duty to ensure that their company does not trade while insolvent; nor does that legislation impose an obligation to ensure that the company does not trade at a loss.⁶⁵ Directors may properly take the view that it is in the interests of the company and of its creditors that, although insolvent, the company should continue to trade out of its difficulties. Then they

60 *Ralls Builders Limited*, *supra* note 47, at pp. 238 and 241.

61 In *Continental Assurance Co of London Plc*, *supra* note 54, J. Park explained the concept of 'increase in net deficiency' as follows in para. 297: "(...) The concept is that, if the directors had decided on 19 July 1991 that Continental was insolvent, and had caused it to be put into liquidation then or soon thereafter, there would have been a deficiency in the hypothetical 1991 liquidation of one amount, say £X. In the actual case Continental did not go into liquidation until 27 March 1992, and in the actual 1992 liquidation there was a deficiency of a different amount, say £Y. If £Y is greater than £X the excess is the increase in net deficiency. (...)" The net deficit approach has been criticised as a perverse incentive for directors to continue to trade as long as they are careful to "rob Peter to pay Paul" and to make sure that the net deficit remains constant. See Gabriel Moss QC in *Insolvency Intelligence*, Vol. 30(4), 2017.

62 Section 214(1) IA 86. In *Loose et al.*, *supra* note 15, at 7.97 it is argued that in the more serious cases where the conduct verged on recklessness, instead of increase in the net deficiency of the company, the liability should be measured based on the depletion in assets attributable to the period after the directors should have realized insolvent liquidation or insolvent administration was inevitable. It should further be noted that Hamish Anderson argues in the Framework of Corporate Insolvency Law, *supra* note 35, at 17.18 that an administration (that is not a liquidating administration) requires a more nuanced approach towards contribution.

63 *Re Produce Marketing Consortium Limited* [1989] 5 BCC 597. See also *Morphits v. Bernasconi & others* [2003] Ch 552, a case concerning fraudulent trading under Section 213 IA 86, in which L.J. Chadwick at para. 55 stated that he was not persuaded that there is power to include a punitive element in the amount of any contribution.

64 *Morphits v. Bernasconi & others*, *supra* note 64, at 55.

65 *Secretary of State for Trade and Industry v. Gash* [1997] BCC 172 at p. 178 at 114. See also Hamish Anderson, *supra* note 35, at 17.14.

may properly take the view that it is in the interests of the company and its creditors that some loss-making trade should be accepted in anticipation of future profitability. They should not be criticized if they give effect to such a view.⁶⁶ The wrongful trading concept has been interpreted by the Courts in a way so as not to require suppression of enterprise and ambition.⁶⁷ Ceasing to trade and liquidating too soon can be stigmatized as the 'cowards' way out'.⁶⁸ These considerations evidence the so-called 'rescue culture' that is being embraced in the UK.⁶⁹

3 SCOPE OF THIS REPORT

The directors' liability addressed in this report is primarily focused on the concept of wrongful trading. Other relevant concepts that will not (except only very briefly below) be addressed in this report are:

- a. Fraudulent trading:⁷⁰ where a company is in liquidation or administration, liability under this concept exists when it is shown that "the business of the company has been carried on with the intent to defraud creditors⁷¹ of the company or creditors of any other person or for any fraudulent purpose."
- b. Misfeasance:⁷² this liability is incurred by a past or present officer⁷³ of a company in liquidation who has (i) misapplied or retained or become accountable for, any money or other property of the company, or (ii) been guilty of any misfeasance or breach of any fiduciary or other duty including negligence in relation to the company, the direct consequence of which misapplication is loss of assets.⁷⁴ In defense of a misfeasance

66 *Secretary of State for Trade and Industry v. Gash*, *supra* note 66, at p. 114.

67 *Langreen Limited (in liquidation)*, *supra* note 49, at p. 65.

68 *Continental Assurance Co of London Plc*, *supra* note 54, at p. 281.

69 In the White Paper 'Modernising Company Law', the UK government was critical about subjecting directors in the zone of insolvency to carry out a balancing of interests exercise because fear of personal liability might lead to excessive caution and this would run contrary to the 'rescue culture', which the UK government is seeking to promote (Mortimore, *supra* note 2, at 12.61 and 12.62).

70 Section 213 IA 86. For fraudulent trading in administration, *see* Section 246ZA IA 86.

71 Defrauding creditors or carrying on a business for a fraudulent purpose requires that there has to have been dishonesty in the running of the business (or reckless indifference as to whether or not creditors were defrauded). *See Re Bank of Credit and Commerce International SA (No. 2), Banque Arabe et Internationale D'Investissement SA v. Morris* [2000], All ER (D) 1437.

72 Section 212 IA 86 creates a simpler procedure and statutory remedy against officers (and others) who breach their duties (statutory, common law or fiduciary). There is a separate misfeasance provision – para.75 of Schedule B1 to the IA 86 – which can be used to challenge the conduct of an administrator or a person who purports to be (or has purported to be) the administrator of a company.

73 Please note that no comprehensive definition of 'officer' exists in either the IA 86 or the CA 2006. Section 1173(1) CA 2006 (incorporated into the IA 86 pursuant to Section 251) states that an officer in relation to a body corporate will include "a director, manager or secretary". Regarding misfeasance, the better view is, however, that it does not include shadow directors (*see Sealy & Milman, Annotated Guide to the Insolvency Legislation 2017* (20th edition) Volume 1, commentary to Section 212(1) IA 86, p. 220).

74 *See Re Idessa (UK) Ltd (in liquidation)*, *supra* note 13.

- claim, a director may attempt to demonstrate that (i) he/she acted honestly and reasonably and (ii) the circumstances of the case mean that it is fair to excuse the director from liability.⁷⁵ A claim for misfeasance is made by the official receiver, the liquidator or any creditor or contributory.⁷⁶ Although a creditor has standing to bring a misfeasance claim, the Court can only make an order in favor of the company, and not the individual creditor.⁷⁷
- c. Fraud in anticipation of winding-up:⁷⁸ where a company goes into liquidation, liability under this concept attaches to a past or present officer of the company who has within the previous 12 months undertaken, in short, any of the following:
- i. Concealed or fraudulently removed any part of the company's property worth £ 500 or more or concealed any debt owed to or from the company;
 - ii. Concealed, destroyed, mutilated, falsified or made a false entry of any records of the company (or relating to the company's property or affairs);⁷⁹
 - iii. Fraudulently parted with, altered or made any omission in any document affecting or relating to the company's property or affairs; or
 - iv. Pawned, pledged or disposed of any property of the company that has been obtained on credit and has not been paid for (unless such action was in the ordinary course of business).
- d. Transactions in fraud of creditors:⁸⁰ where a company goes into liquidation, liability under this concept attaches to an officer of the company who (i) has made or caused to be made any gift, or transfer of, or charge on, or has caused or connived at the levying of any execution against the company's property or (ii) has concealed or removed any part of the company's property since, or within 2 months before, the date of any unsatisfied judgment or order for payment of money obtained against the company.
- e. Misconduct in course of winding-up:⁸¹ where a company goes into liquidation, liability under this concept attaches to an officer of the company who:
- i. Does not, to the best of his/her knowledge and belief, fully and truly discover to the liquidator all of the company's property, and how and to whom and for what

75 Section 1157 CA 2006. See Sealy & Milman, *supra* note 74, p. 222.

76 Section 212(3) IA 86. The power of a contributory to make a misfeasance claim is not exercisable except with the leave of the Court, but is exercisable notwithstanding that he will not benefit from any order of Court (Section 212(4) IA 86).

77 *Kyrris v. Oldham* [2003] EWCA Civ 1506. An administrator is not given standing under Section 212(3) IA 86, but he/she may make a misfeasance claim in the name of the company (*Irwin v. Lynch* [2010] EWCA Civ 1153). An assignee of a creditor's claim does have standing (*Mullarkey v. Broad* [2007] EWHC 3400 (Ch)). See also, Sealy & Milman, *supra* note 74, at p. 222.

78 Section 206 IA 86.

79 See also the separate offence of 'falsification of company's books' under Section 209 IA 86.

80 Section 207 IA 86.

81 Section 208 IA 86.

- consideration and when the company disposed of any part of that property not disposed in the ordinary course of business;
- ii. Does not deliver up to the liquidator all of the company's property (including all books and papers) in his/her custody or control;
 - iii. Knowing or believing that a false debt has been proved by any person in the winding-up, fails as soon as practicable to inform the liquidator;
 - iv. After the commencement of the winding-up, prevents the production of any book or paper affecting or relating to the company's property or affairs; or
 - v. Attempts to account for any part of the company's property by fictitious losses or expenses or attempted to do so at a meeting of the company's creditors within 12 months of the commencement of the winding-up.
- f. Material omissions from statement relating to company's affairs:⁸² where a company goes into liquidation, liability under this concept attaches to a past or present officer of the company who makes any material omission in any statement relating to the company's affairs (including omissions in any such statement prior to the winding-up).
- g. False representations to creditors:⁸³ where a company goes into liquidation, liability under this concept attaches to a past or present officer of the company who makes any false representation or commits any other fraud for the purpose of obtaining consent of the company's creditors or any of them to an agreement with reference to the company's affairs or to the winding-up.
- h. Reusing a prohibited company name:⁸⁴ it is prohibited for any person, who was either a director or shadow director of the company at any time during the period of 12 months ending with the company's insolvent liquidation,⁸⁵ to be concerned in another company that uses the insolvent company's name (trading name or registered name) or a name similar to that name so as to suggest an association with it.⁸⁶ Except with leave of the Court, a (shadow) director is not permitted for a period of 5 years from the date of the commencement of the relevant liquidation (i) to be a director of any company that is known by a prohibited name, (ii) in any way, whether directly or indirectly, to be concerned or take part in the promotion, formation or management of such a company, or (iii) in any way, whether directly or indirectly, to be concerned with or take part in the carrying on of a business carried on (otherwise than by a company) under the prohibited name.⁸⁷ Personal liability is incurred by a person for all the relevant debts of a company if at any time (i) in contravention of the

82 Section 210 IA 86.

83 Section 211 IA 86.

84 Sections 216 and 217 IA 86. This prohibition aims to prevent the so-called 'phoenix syndrome', On 'phoenixism'; see also Hamish Anderson, *supra* note 35, at 18.02-18.13.

85 Section 216(1) IA 86.

86 Section 216(2) IA 86.

87 Section 216(3) IA 86.

prohibition he is involved in the management of the company or (ii) as a person who is involved in the management of the company, he acts or is willing to act on instructions given (without the leave of the court) by a person whom he knows at that time to be in contravention of the prohibition in relation to the company.⁸⁸

3.1 *Avoidance of Antecedent Transactions*

In addition, there are a number of grounds on the basis of which so-called antecedent transactions can be avoided under English law, including the following, which will also not be addressed in this report (except only very briefly as follows):⁸⁹

- a. Transactions at an undervalue:⁹⁰ the company enters into a transaction with a person at an undervalue if (i) the company makes a gift to that person or otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration or (ii) the company enters into a transaction with that person for a consideration the value of which, in money or money's worth, is significantly less than the value in money or money's worth, than the consideration provided by the company.⁹¹ The challenge must be brought by an office-holder,⁹² it must relate to a transaction entered into by the company with any person⁹³ at the relevant time⁹⁴ and the challenged transaction must have resulted in an inability by the company to pay its debts.⁹⁵ However, a challenge will not be successful if a Court is satisfied that (i) the company that entered into the transaction did so in good faith and for the purpose of carrying on its business and (ii) at the time it did so there were reasonable grounds for believing that the transaction would benefit the company.⁹⁶
- b. Preferences:⁹⁷ a company gives a preference to a person if (i) that person is one of the company's creditors or a surety or guarantor for any of the company's debts or other liabilities and (ii) the company does anything or suffers anything to be done that (in either case) has the effect of putting that person into a position which, in the event of the company going into an insolvent liquidation, will be better than the position he

88 Section 217(1) IA 86.

89 See, generally, chapter on England and Wales by Peter Declercq and Shan Qureshi, *Avoidance of Antecedent Transaction*, 2014, INSOL International publication, pp. 111-139.

90 Section 238 IA 86.

91 Section 238(4) IA 86.

92 Section 238(1) IA 86, which means the company needs to be in either administration or liquidation.

93 Section 238(2) IA 86.

94 Section 240 IA 86. There is a look-back period of 2 years before the onset of insolvency.

95 Section 240(2) IA 86. For transactions with a 'connected party' (as defined in Section 249 IA 86. Section 435 IA 86), a rebuttable presumption exists regarding the inability to pay its debt requirement.

96 Section 238(5) IA 86.

97 Section 239 IA 86.

would have been in if that thing had not been done.⁹⁸ This challenge must also be brought by an office-holder,⁹⁹ the challenged transaction must be entered into at the relevant time¹⁰⁰ and must have resulted in an inability by the company to pay its debts.¹⁰¹ For the challenge to be successful, it must further be demonstrated that the company that gave the preference was influenced in deciding to give it by the desire to bring about a preference in relation to that person (the 'preference desire').¹⁰² For a transaction with a connected party (who is not only an employee), there is a rebuttable presumption in respect of the preference desire requirement.¹⁰³

- c. Disclaimer of onerous properties:¹⁰⁴ onerous property¹⁰⁵ consists of (i) any unprofitable contract, and (ii) any other property of the company that is unsaleable or not readily saleable or is such that it may give rise to a liability upon the company to pay money or perform any other onerous act.¹⁰⁶ Only liquidators have the power to disclaim onerous property.¹⁰⁷ A disclaimer (i) acts to identify the rights, interests and liabilities of the company in or in respect of the property being disclaimed and (ii) does not, except so far as is necessary for the purpose of releasing the company from any liability, affect the rights and liabilities of any other person.¹⁰⁸
- d. Extortionate Credit Transactions:¹⁰⁹ a transaction is extortionate if, having regard to the risk accepted by the person providing the credit, (i) the terms of it are or were such as to require grossly exorbitant payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of the credit or (ii) it otherwise

98 Section 238(4) IA 86. The fact that something has been done in pursuance of the order of the Court does not, without more, prevent the doing or suffering of that thing from constituting the giving of a preference (Section 238(7) IA 86).

99 Section 239(1) IA 86. This can be a liquidator or an administrator.

100 Section 240 IA 86. For transactions with a connected party (not only being an employee) the look-back period is 2 years from the onset of insolvency. For all other transactions, the look-back period is 6 months from the onset of insolvency.

101 Section 240(2) IA 86.

102 Section 239(5) IA 86. If the company is driven in its action by a desire to make proper commercial considerations, rather than a desire to give a preference, then the preferential act will still be valid (*Re Fairway Magazines Limited* [1992] BCC 924). It is insufficient in itself that a company had a desire to benefit a preferred creditor, unless that desire actually influenced the decision to give the preference (R. Parry, J. Ayliffe and S. Shivji, *Transaction Avoidance in Insolvencies*, 2nd edition, 2011, at 5.96).

103 Section 239(6) IA 86.

104 Sections 178-182 IA 86. The power to disclaim ownership of onerous property is an unconventional avoidance power in that it does not enable augmentation of the assets of the estate available to creditors, but is aimed instead at the disposal of assets in order to limit the liabilities of the insolvent company (Parry *et al.*, *supra* note 103, Chapter 7 at 7.01).

105 The term 'property' is widely defined in Section 346 IA 86 as including "money, goods, things in action, land and every description of property wherever situated and also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property."

106 Section 178(3) IA 86.

107 Section 178(1) IA 86.

108 Section 178 (4) IA 86.

109 Section 244 IA 86.

grossly contravened ordinary principles of fair dealing.¹¹⁰ This challenge must be brought by an office-holder¹¹¹ and the challenged transaction must have been entered into by the company at a relevant time.¹¹² There is a broad range of remedies the Court can order.¹¹³

- e. Avoidance of Floating Charges:¹¹⁴ this challenge must be brought by an office-holder.¹¹⁵ The challenged floating charge must be given by the company at the relevant time¹¹⁶ and it must not be given in exchange for new consideration.¹¹⁷ Except if the challenged floating charge is given in favor of a connected party, the relevant time requirement can only be met if the company is, at that time, unable to pay its debts or becomes unable to pay its debts in consequence of the challenged floating charge.¹¹⁸
- f. Transactions Defrauding Creditors (TDC):¹¹⁹ a TDC challenge can be brought by an office-holder and by a 'victim' of the challenged transaction (TDC Victim).¹²⁰ The challenged transaction must be at an undervalue¹²¹ and the company must have entered the challenged transaction for the purpose of: (i) putting assets beyond the reach of a person who is making, or may at some time make, a claim against the company or (ii) otherwise prejudicing the interests of such a person in relation to the claim which he is making or may make.¹²² There is no time limit (or look-back period) for a TDC challenge.

Except for a TDC challenge, which can also be brought outside of insolvency proceedings, each of the above grounds to avoid antecedent transactions require the company that entered into the challenged transaction to be subject to an insolvency proceeding. The involvement of directors in any antecedent transactions that are successfully challenged

110 Section 244(3) IA 86. As a statutory rebuttable presumption exists that the challenged transaction is exorbitant, the burden of proof always rests on the person that provided the company with the credit.

111 Section 244(1) IA 86. The office-holder can be an administrator or liquidator.

112 Section 244(2) IA 86. The look-back period is a period of 3 years ending with the day on which the company entered into administration or went into liquidation.

113 Section 244(4) IA 86.

114 Section 245 IA 86.

115 Section 245(1) IA 86. The office-holder could be an administrator or liquidator.

116 Section 245(3) IA 86. The look-back period is 12 months from the onset of insolvency (Section 245(5) IA 86). If the challenged floating charge is given for the benefit of a connected party, the look-back period is extended to 2 years.

117 Section 245(2) IA 86. The purpose of this avoidance power is to prevent companies on their last legs from creating floating charges (i) to secure past debts or (ii) for moneys which do not go to swell their assets and become available for creditors (*Re Orleans Motor Co Ltd* [1911] 2 Ch 41 at p. 45).

118 Section 245(4) IA 86.

119 Section 423 IA 86.

120 Section 424(1) IA 86. A TDC Victim is widely defined and does not need to be a person whom the company had in mind when entering into the challenged transaction (*Fortress Value Recovery Fund v. Blue Skye Special Opportunities Fund* [2013] EWHC 14 (Comm)).

121 Section 423(1) IA 86.

122 Section 423(3) IA 86.

may create a separate basis for directors' liability and are therefore also relevant for directors to consider when their company is in the zone of insolvency.¹²³

3.2 *Company Directors' Disqualification Act 1986 (CDDA)*

The Court must disqualify a person who is or has been a director of a company that has become insolvent at any time if it is satisfied that his/her conduct (including his/her conduct as a director of any other company)¹²⁴ makes him/her unfit to be concerned in the management of a company.¹²⁵ Applications for such disqualification under the CDDA are made by the Department for Business Innovation and Skills (BIS) or by the Official Receiver, who may be instructed to apply by BIS where a company is being compulsorily wound up.¹²⁶ This action will usually be triggered by a statutory report by an office-holder.¹²⁷ The primary objective is not to punish delinquent directors, but to disqualify where that is necessary to protect the public against future misconduct.¹²⁸ The minimum period of disqualification is 2 years and the maximum period is 15 years.¹²⁹ Unfitness should be treated as a question to be decided on a case-by-case basis and is not dependent upon a finding of 'total' incompetence.¹³⁰ However, disqualification is unlikely to be ordered where bad luck and unforeseeable misfortune has played a large part in the company's downfall.¹³¹ A middle ground must be found between bad luck and the sort of willful disregard of the interests of creditors and the company that undoubtedly merits disqualification and falls little short of dishonesty.¹³² The repayment of a loan to a creditor in circumstances amounting to a preference was, however, held to be sufficient to justify disqualification.¹³³ Contravention of a disqualification order carries both criminal and civil liabilities.¹³⁴

123 See Mortimore, *supra* note 2, at 34.109.

124 While the conduct of a director in relation to other companies may be looked at by the Court as an indication that the director should be disqualified, it may not be looked at in mitigation of this conduct in respect of the insolvent company (See Loose *et al.*, *supra* note 15, at 7.49).

125 Section 6 CDDA. Section 10(1) CDDA also allows the Court to make a disqualification order in those cases where the Court concludes a person is liable to make a contribution based on either fraudulent trading (Section 213 IA 86) or wrongful trading (Section 214 IA 86).

126 Section 7 CDDA.

127 See, generally Insolvent Companies (Report on Conduct of Directors) Rules 1996.

128 See Loose *et al.*, *supra* note 15, at 7.51.

129 Section 6(4) CDDA.

130 *Re Sevenoaks Stationers Ltd* [1990] 3 WLR 1165.

131 See Loose *et al.*, *supra* note 15, at para. 7.52.

132 *Ibid.*, at para. 7.53.

133 *Re Living Images Ltd* [1996] BCC 112.

134 Section 13 CDDA 1986 makes acting in contravention of a disqualification order a criminal offence carrying, on indictment, imprisonment for up to 2 years and a fine. For fines, see Section 430 IA 86 and Schedule 10 to the IA 86. Section 15 CDDA makes a person who acts in contravention of a disqualification order and is involved in the management of the company personally responsible for all relevant debts of that company.

4 SPECIFIC QUESTIONS

4.1 *To what extent do directors run special risks in the context of a restructuring when they enter into new obligations, including new secured financing?*

- a. While in the zone of insolvency, directors can enter into new obligations (see in particular Section 2.6 of this report on rescue culture). However, doing so requires directors to consider the concepts of wrongful trading, misfeasance and possibly also fraudulent trading. As mentioned in Section 3(b) of this report, a claim for misfeasance can be brought for breach of any of the codified directors' duties.¹³⁵ The insolvency legislation regarding misfeasance also extends to cover the duty of care owed to a company at common law.¹³⁶
- b. As indicated in Section 1 of the report, in the zone of insolvency the directors' duty to promote the success of the company changes from a duty to promote the success of the company for the members as a whole to a duty to the creditors of the company, whose interests are – in these circumstances – paramount. So the directors must consider the interests of the company and its creditors when deciding to enter into new obligations while the company is in the zone of insolvency. These interests are separate and distinct from the interests of other associated or group companies or any other companies in which the director in question might be interested. If the new obligations entered into are contrary to the best interests of the company (and its creditors), the directors would be deemed to be without authority and therefore any agreement entered into on that basis would not bind the company.¹³⁷
- c. When considering whether to enter into new obligations while the company is in the zone of insolvency, directors must focus on whether the transaction is to the detriment of creditors.¹³⁸ The directors must ensure that the company will receive full value. If full value is not attainable, the directors must be satisfied (and have reached the decision in good faith) that entry into the transaction is to enable the continuation of the business and there are reasonable grounds to believe the transaction will benefit the company. Failure to satisfy themselves of this may lead to breach of their statutory duties to creditors and liability for misfeasance.¹³⁹

This is a joint and several liability for those debts together with the company and other persons who may be held liable for them.

135 *Re Westlowe Storage and Distribution Ltd* [2000] 2 BCLC 590.

136 *Re D'Jan of London Ltd, Copp v. D'Jan* [1994] 1 BCLC 561 at 563.

137 *Re Capitol Films Ltd (in administration); Rubin and another v. Cobalt Pictures Ltd and others* [2011] 2 BCLC 359.

138 *Singularis Holdings Ltd v. Daiwa Capital Markets Europe Ltd* [2017] 2 All ER (Comm) 445.

139 See Mortimore, *supra* note 2, at 12.71.

- d. Alongside the duty to promote the success of the company, also the duty to exercise reasonable care, skill and diligence might become important in the context of entering into new obligations while the company is in the zone of insolvency. When entering into new obligations, directors must exercise the care, skill and diligence that would be exercised by a reasonably diligent person with the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and the general knowledge, skill and experience that the director has.¹⁴⁰ What exactly this is, will have to be determined on a case-by-case basis, but if the director falls below the standard, he/she may be in breach of his/her statutory duties and if the company is in liquidation, guilty of misfeasance.
- e. The wording of the statutory duty to exercise reasonable care, skill and diligence closely mirrors the wrongful trading legislation.¹⁴¹ Indeed, a director may be found to be guilty of wrongful trading if they enter into new obligations or new secured financing. There is close interplay between misfeasance and wrongful trading such that if found liable for misfeasance, a director may also be found liable for wrongful trading.¹⁴² The recoveries available with regard to each are, however, different. A claim for misfeasance is made on behalf of the company¹⁴³ and the Court has discretion to order contribution to the company's assets in such sum as it thinks just.¹⁴⁴ This is in contrast to recoveries under a wrongful trading claim, which, as set out in Section 2.6 of this report, are limited to the increase in the net deficiency of the company. If the directors' duty to minimize loss is triggered under wrongful trading legislation, and misfeasance occurs thereafter, then usually any recovery for misfeasance will reduce directors' liability for wrongful trading.¹⁴⁵ In contrast, if misfeasance occurs before the duty to minimize loss, separate payments will be ordered.¹⁴⁶
- f. For wrongful trading purposes, the key question in this context is whether the no reasonable prospect requirement has been met when the new obligation or the new secured financing is entered into. If the no reasonable prospect requirement has been met, then the director must, in order to benefit from the every step defense, do everything to minimize losses to creditors. Matters can get complicated if, for example, it is in the best interest of the existing creditors of the company to avoid an insolvency proceeding and instead sell the assets on a going concern basis, but in order to continue to trade for the duration of the sales process, new financing is required. For any

140 Section 174 CA 2006. See also Section 2.2 of this report.

141 See Mortimore, *supra* note 2, Chapter 14 (Duty to exercise reasonable care, skill, and diligence) by M. Arnold QC, at 14.02.

142 See Mortimore, *supra* note 2, at 34.27.

143 *Kyrris v. Oldham*, *supra* note 78.

144 Section 212 IA 86. See also Section 3(b) of this report.

145 *Re DKG Contractors Ltd* [1990] BCC 903.

146 *Re Purpoint Ltd* [1991] BCLC 491.

new creditor that comes into the picture for the first time during this period, it is of little comfort to know that the already existing creditors are going to get a better dividend on their debts as a result of the continued trading and sale as a going concern. If it can be said that the director was dishonest in incurring the new secured credit even though doing his/her best for the general body of creditors, the concept of fraudulent trading may become relevant as well.¹⁴⁷

- 4.2 *To what extent do directors run special risks in the context of restructuring when they engage in 'selective payment' (i.e., they decide to pay certain creditors while leaving other creditors unpaid)?*
- a. Whether selective payments made by directors in the context of restructuring could result in liability for them requires an assessment of the concept of wrongful trading as well as the concept of preferences, both of which have already been touched upon above in Parts 2 and 3 of this report. If there is a reasonable prospect that the company can avoid an insolvent liquidation or insolvent administration and therefore 'turn the corner', then, in that context, it may be argued that the making of selective payments by the directors is acceptable if it can be demonstrated that they did not qualify as a preference. If the making of selective payments does not amount to a preference and supports the reasonable prospect that is legitimately being pursued by the company, then a challenge of such directors' conduct may not result in liability for the directors.
 - b. However, if the Court is satisfied that by making the selective payments, a preference to a particular creditor has been given by the directors, the Court may make an order as it sees fit to restore the position to what it would have been had the company not entered into the transaction or given the preference.¹⁴⁸ Upon insolvency, a Court finding that a preference has been given to a particular creditor will not necessarily lead to a director being liable for wrongful trading, though directors found to have given preferences to particular creditors may be found to be in breach of their duty to minimize loss to creditors as a whole and therefore not benefit from the 'every step defense'.¹⁴⁹
 - c. Case law has evidenced that the ability to establish and prove the preference desire¹⁵⁰ may be a point of contention. In establishing the preference desire, it is not necessary to establish a dominant intention to prefer.¹⁵¹ Also, it is insufficient in itself that a

147 See chapter on England and Wales by Gordon Stewart and Rupert Cheetham in INSOL International publication *Directors in the Twilight Zone V*, 2017, at 4.12.

148 Section 239 IA 1986. As set out in Section 241 IA 86, a number of orders can be made by the Court to restore the position, though it is clear from the wording that the list is not exhaustive.

149 Section 172 CA 2006.

150 Section 239(5) IA 86. See also Section 3(b) of this report.

151 *Re MC Bacon Ltd* [1990] BCC 78.

company had a desire to benefit a preferred creditor, unless that desire actually influenced the decision to give the preference.¹⁵² If the company is driven in its action by a desire to make proper commercial considerations (for example, the pursuit of a reasonable prospect to avoid an insolvent liquidation or insolvent administration), rather than a desire to give a preference, then the preferential act will still be valid.¹⁵³ The preference desire must go further than proving a desire to make the payment or grant the security, as the case may be; there must be a desire to improve the creditor's position in the event of an insolvent liquidation or insolvent administration.¹⁵⁴ Given a preference desire is subjective, little or no evidence may exist to prove it. The preference desire may be inferred from the particular circumstances, but must have influenced the decision to enter into the transaction.¹⁵⁵

- d. In establishing the preference desire, case law has identified various situations in which a preference desire will and will not be found to exist. For example, the Court has previously narrowed the ability to find a preference desire such that a preference desire will not be found where the intention of the company or the directors was to regulate the relationship between the bank and the company and to promote stability in the company,¹⁵⁶ nor will a debenture granted by the company be classed as a preference where this is given with the desire to raise further finance for the company in the hope of achieving its rescue.¹⁵⁷ In contrast, if the defendants had also intended to keep the company afloat through further financing but the relationship between this and the preference desire is not adequate to indicate a preference desire was absent, a preference will be found by the Courts.¹⁵⁸
- e. From the above it follows that there is no absolute prohibition for directors to make selective payments in the context of a restructuring. Before causing the company to make certain selective payments to certain creditors, the directors should consider whether they are necessary in the interests of the company having regard to the interests of creditors generally.¹⁵⁹ Whether it is allowed or not is very fact-specific and requires directors to keep a close eye on both the wrongful trading concept and the preferences concept. While directors acting in the zone of insolvency run risks, they are not running any *special* risks when making selective payments in the context of a restructuring. More generally, it is prudent for directors to keep a detailed written record when in or close to the zone of insolvency and hold regular full board meetings

152 Parry *et al.*, *supra* note 103, at 5.96.

153 *Re Fairway Magazines Limited*, *supra* note 103.

154 *Re MC Bacon Ltd*, *supra* note 152.

155 *Ibid.*

156 *Re Oxford Pharmaceuticals; Wilson and another v. Masters International Ltd and another* [2009] EWHC 1753 (Ch)

157 *Re Fairway Magazines Limited*, *supra* note 103.

158 *Re Conegrade Ltd* [2002] EWHC 2411 (Ch).

159 See Mortimore, *supra* note 2, at 12.97.

to consider the company's financial position with detailed minutes reflecting discussions, options considered, plans, projections, assumptions and providing fully reasoned explanations for decisions made.¹⁶⁰ Doing so will assist in any defense of a preference challenge. The same applies to taking timely independent professional advice, both financial and legal, on which the Courts will place some reliance in assessing a challenge.¹⁶¹

4.3 *To what extent*

4.3.1 **does a general duty exist for directors to file for insolvency proceedings under certain circumstances (e.g., balance sheet insolvency, inability to pay)?**

- a. Neither the CA 2006 nor the IA 86 imposes on directors a statutory duty to ensure that their company does not trade while insolvent and there is not an obligation to ensure that the company does not trade at a loss either. While directors should file for insolvency under certain circumstances, a general duty to file for insolvency at a certain predetermined point in time does not exist. Instead, when their company is in or close to the zone of insolvency, directors should use the concept of wrongful trading as a compass to determine when the circumstances are such that continued trading would be wrongful and a reasonable prospect to avoid an insolvent liquidation or insolvent administration no longer exists.
- b. Directors may properly take the view that some loss-making trade should be accepted in anticipation of future profitability.¹⁶² Indeed, directors may hold off on filing for insolvency and legitimately consider the prospects of raising additional capital from an external investor to restore company solvency.¹⁶³ When a company gets into financial trouble, directors are faced with an 'unenviable dilemma'.¹⁶⁴ If they continue to trade and unfortunately the situation cannot be salvaged, they may find themselves faced with a wrongful trading claim upon liquidation. Alternatively, if the directors decide to close down and go into an early liquidation, while the risk of wrongful trading may be removed, they are more than likely to face criticism from other parties and stigmatized as taking the 'cowards' way out'. An immediate closedown would

¹⁶⁰ *Ibid.*, at 12.96.

¹⁶¹ *Ralls Builders Limited*, *supra* note 47, at pp. 200-210. However, it should be noted that reliance on professional advice is not going to assist directors if that advice is predicated on the directors' stated belief that the company will be able to avoid insolvent liquidation if in light of the directors' actual knowledge, there is no reasonable basis for that belief (*Re Rod Gunner Organisation Ltd; Rubin v. Gunner and another* [2004] EWHC 316 (Ch) at 104-117).

¹⁶² *Secretary of State for Trade and Industry v. Taylor* [1997] 1 WLR 407.

¹⁶³ *Ralls Builders Limited*, *supra* note 47.

¹⁶⁴ *Continental Assurance Co of London Plc*, *supra* note 54, at p. 281.

likely mean that the company enters into insolvent liquidation, which, as well as being costly, may also mean that debtors are less inclined to pay the company.¹⁶⁵

4.3.2 do exceptions to the general duty as mentioned in item 4.3.1 (a) exist?

- a. Since there is no general duty to file for insolvency in the UK, this question is not applicable.

4.3.3 do the rules addressed in items 4.3.1 (a) and (b) have a restricting effect in practice?

- a. Given the lack of a general duty to file for insolvency under English law, there is no restrictive effect in practice. In fact, it is quite the opposite. The 'rescue culture' in the UK means that companies and their directors have greater flexibility in deciding whether to continue trading at a loss or filing for insolvency. See also Section 2.6 of this report.

4.3.4 does a prohibition on 'wrongful trading' exist and what are the consequences if a business is continued too long?

- a. In the UK, a prohibition on wrongful trading does indeed exist. The elements required to establish a successful claim for wrongful trading and also the consequences of a wrongful trading finding are addressed in Section 2 of this report.

4.4 *To what extent are directors (jointly and/or severally) liable for the payment by the company of its tax and social security obligations?*

- a. In the UK, the liability for the payment of tax and social security obligations lies with the company and not with the directors.¹⁶⁶

¹⁶⁵ *Ibid.*

¹⁶⁶ Any corporation tax obligations of the company may be classed as a liquidation expense of the company if the tax arises during the liquidation process (*Re Toshoku Finance UK plc, Kahn and others v. Commissioners of Inland Revenue* [2002] 1 BCLC 59). Certain obligations such as wages and salaries of employees have preferential status upon liquidation (paras. 8 and 9 of Schedule 6 to IA 86).

- b. However, the Inland Revenue can issue a personal liability notice to a director if national insurance contributions have not been paid and this appears to be due to fraud or neglect of the director.¹⁶⁷ Neglect in this instance is an objective test.¹⁶⁸

5 ARTICLE 18 OF THE PROPOSED DIRECTIVE ON PREVENTIVE RESTRUCTURING FRAMEWORKS¹⁶⁹

In the Explanatory Memorandum to the Proposal,¹⁷⁰ the key objective of the Proposal is described as reducing the most significant barriers to the free flow of capital stemming from differences in member states' restructuring and insolvency frameworks. The key principles on effective preventive restructuring and second chance frameworks set forth in the Proposal aim to help increase investment and job opportunities in the single market, reduce unnecessary liquidations of viable companies, avoid unnecessary job losses, prevent the buildup of nonperforming loans, facilitate cross-border restructurings, and reduce costs and increase opportunities for honest entrepreneurs to be given a fresh start. This includes rules on company managers' duty of care when nearing insolvency, as this is to play an important role in developing a culture of rescue instead of liquidation. These rules should encourage early restructuring and prevent misconduct and avoidable losses for creditors.

Article 18 of the Proposal requires member states to lay down rules to ensure that, where there is a likelihood of insolvency, directors have the following obligations: (i) to take immediate steps to minimize the loss for creditors, workers, shareholders and other stakeholders; (ii) to have due regard to the interests of creditors and other stakeholders; (iii) to take reasonable steps to avoid insolvency; and (iv) to avoid deliberate or gross negligent conduct that threatens the viability of the business. To what extent does existing English law on directors' liability in the zone of insolvency need to be amended to comply with Article 18 of the Proposal?

- a. The first obvious point to make is that the so-called 'Brexit' decision made by the UK makes it difficult at present to accurately predict whether the UK will ever be bound by the Proposal after it has become an EU Directive. Assuming, however, for the

¹⁶⁷ Section 121C Social Security Administration Act 1992.

¹⁶⁸ *Revenue and Customs Commissioners v. O'Rourke* [2013] UKUT 0499 (TCC). The standard for the objective test is what a reasonable prudent man of business would have done (para. 4). It is a standard of conduct, not a standard of state of mind (para. 69).

¹⁶⁹ Proposal of 22 November 2016 (2016/0359 (COD)) for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30 EU (the 'Proposal').

¹⁷⁰ Explanatory Memorandum to the Proposal, pp. 5 and 6.

purposes of this report, that Article 18 of the Proposal is relevant to the UK, there are number of initial observations to make.

- b. As addressed in Section 2.6 of this report, the UK already has a rescue culture in which directors are encouraged to continue to trade (even when the company is (cash-flow and/or balance sheet) insolvent and/or trades at a loss) as long as rational expectations exist that there is a reasonable prospect for the company to avoid an insolvent liquidation or an insolvent administration. That flexibility embedded in (the application and interpretation of) the concept of wrongful trading already provides directors with an appropriate incentive to attempt a restructuring in a timely manner rather than being forced into a premature insolvency filing out of fear for personal liability (see also Section 4 of the report).
- c. The wrongful trading concept (as discussed in Section 2 of the report) as well as the related concepts (highlighted in Section 3 of the report) are tools that already exist under English law to deal with (and discourage) deliberate and grossly negligent conduct by directors that threatens the viability of the business of the company when it is in the zone of insolvency.
- d. The codified directors' duties as addressed in Sections 1.1 of this report already require directors to have regard to interests of the various stakeholders of the company. However, when the company is in the zone of insolvency, the interests of the creditors become paramount and the focus of the directors shifts from doing what is in the best interest of the members of the company to what is in the best interest of the creditors of the company.
- e. From the quite generic wording of Article 18 of the Proposal, it is unclear whether the current practice in the UK requires adjustment or change.¹⁷¹ This raises a number of questions, including:
 - i. Aside from the creditors, the interests of which other stakeholders should be the focus of directors of a company in the zone of insolvency?
 - ii. Is it OK for the interests of the creditors to be paramount when the company is in the zone of insolvency?
 - iii. What exactly is meant by 'a likelihood of insolvency'? Is it in essence the same as the English case law guidance on the zone of insolvency addressed in Section 1.2 of the report?
 - iv. What exactly is meant by 'reasonable steps to avoid insolvency'? Under English law this is determined on a case-by-case basis applying the concept of wrongful

171 In Gerard McCormack, 'Corporate Restructuring Law – A Second Chance for Europe', *European Law Review*, 42(4), pp. 532-561, at pp. 545/546, 2017, McCormack observes in respect of Art. 18 of the Proposal that "(...) It might be argued, however, that the proposed European norm [as set forth in article 18] is internally contradictory. At one stage it seems to postulate a duty to take reasonable care – 'reasonable steps to avoid insolvency' – but at another point it suggests the somewhat laxer duty of only having to avoid 'grossly negligent' conduct which implies a greater margin of appreciation and tolerance of error. (...)"

trading (and possibly other related concepts as highlighted in Section 3 of the report) to the conduct and decisions made by the directors.

- v. As long as the no reasonable prospect requirement is not met (see Section 2.3 of the report), directors can continue to trade the company and only after the no reasonable prospect requirement is met, in order to benefit from the every step defense (*see* Section 2.4 of the report) and avoid liability, directors must take every step to minimize the potential loss to the company's creditors. Article 18 of the Proposal, however, requires 'immediate steps' to be taken and not only mentions minimizing the loss for creditors, but also specifically mentions 'workers, shareholders and other stakeholders'. Again, what does this mean? It is not clear if something different from the existing UK practice is contemplated.

Executive Summary for NVR II Report

OUTLINE OF THE REPORT

In 2013 the UNCITRAL Legislative Guide¹ acknowledged that the nature and extent of the obligations directors might have in the period when the business might be experiencing financial distress but is not yet insolvent or subject to insolvency proceedings (*i.e.*, 'in the zone of insolvency') are not well established. They are, however, increasingly the subject of extensive debate, particularly in view of the widespread failures following the global financial crisis of 2008. The debate continues and this report:

- a. provides in Parts 1-3 an English law perspective on directors' liability in the zone of insolvency;
- b. addresses a number of specific questions in Part 4; and
- c. ends in Part 5 with a brief discussion of Article 18 (regarding duties of directors) of the proposed Directive on Preventive Restructuring Frameworks² and an initial assessment of whether relevant English law can be considered compliant with this article (assuming it would apply to the UK).

RESCUE CULTURE

Under English law, directors' duties are derived from common law and equitable principles, but they are also codified in the Companies Act 2006 (CA 2006).³ The UK embraces the so-called 'rescue culture', when considering directors' liabilities in the zone of insolvency.⁴ In general terms, this means that directors should be given sufficient flexibility so as to allow them, without unnecessary fear for personal liability or excessive caution, to make an honest attempt to try and rescue the company or its business. Ceasing to trade and liquidating too soon can be stigmatized as the 'cowards' way out', undermining the rescue culture.

1 See UNCITRAL Legislative Guide on Insolvency Law – Part four: Directors' obligations in the period approaching insolvency ("UNCITRAL Legislative Guide"), United Nations Commission on International Trade Law, 2013, Chapter I (Background) at para. 3.

2 For a brief discussion of the Proposal and an initial assessment of its Art. 18, see Part 5 of this report.

3 See in particular Sections 171-177 CA 2006, which are briefly addressed in Sections 1.2-1.4 of this report.

4 The 'rescue culture' is specifically addressed in Section 2.10 of this report. See also Section 4.3.1(b) of this report.

CREDITORS' INTERESTS PARAMOUNT IN THE ZONE OF INSOLVENCY

It is further important for directors to take account of the fact that under English law, when the company enters the zone of insolvency, the focus of the directors' duties changes.⁵ In the zone of insolvency, the interests of the creditors become paramount over those of the members/shareholders of the company. This shift in focus strongly colors how directors' conduct and actions in the zone of insolvency are assessed. It is therefore essential for directors to know when they are in the zone of insolvency. While case law does provide some guidance,⁶ it unfortunately is rather imprecise. When exactly a duty to consider the interests of the creditors arises will therefore have to be determined on a case-by-case basis.

FOCUS ON WRONGFUL TRADING

A breach of one or more of the directors' duties could result in directors' liability based on misfeasance. A simplified procedure and statutory remedy for misfeasance is contained in Section 212 of the Insolvency Act 1986 (IA 86). The concept of misfeasance, together with a number of other relevant concepts under English law that directors should keep in mind when acting in the zone of insolvency (including a number of grounds on the basis of which transactions might be avoided (*e.g.*, transactions at undervalue and preferences) and possibly disqualification under the Company Directors' Disqualification Act 1986), are only briefly touched upon in Part 3 of this report. The focus of the report is, however, on the concept of wrongful trading as set forth in Section 214/246ZB IA 86.

DIRECTORS COVERED BY WRONGFUL TRADING⁷

Wrongful trading is a 'fault'-based liability⁸ that applies to both directors and shadow directors of companies that at some point have gone into insolvent liquidation or insolvent administration. A director is any person occupying the position of director by whatever name called (*i.e.*, both *de jure* and *de facto* directors). A shadow director, on the other hand, is a person in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow

5 See in particular Section 1.3 of this report.

6 See in particular Sections 1.5-1.8 of this report.

7 See in particular Section 2.2 of this report.

8 More generally, for a useful list of examples of behaviour by directors that could constitute a fault in management, see UNCITRAL Legislative Guide, *supra* note 1, Chapter II (Elements of directors' obligations in the period approaching insolvency) at para. 21.

director by reason only that the directors act on the advice given by that person in a professional capacity).⁹

THE 'NO REASONABLE PROSPECT' REQUIREMENT¹⁰

As part of the 'rescue culture' embraced in the UK, there is no firm duty on directors to file for insolvency proceedings at a certain predetermined point in time. The concept of wrongful trading functions in practice as a compass for directors to assess if and when trading should stop. The idea behind wrongful trading is that, at some point in time prior to the commencement of insolvency proceedings, the (shadow) director knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation or insolvent administration. When this so-called 'no prospect' requirement is met, the continuation of trading is deemed wrongful. There is both an objective and subjective standard, using a reasonably diligent person having general knowledge, skill and experience, to assess whether the 'no reasonable prospect' requirement is met. Again, while case law does provide imprecise guidance, this really requires a case-by-case determination. For a director it is important to expressly raise the 'no reasonable prospect' question and consider it directly, closely and frequently. In short, it cannot be ignored.

THE 'EVERY STEP' DEFENSE¹¹

When the 'no reasonable prospect' requirement is met, liability based on wrongful trading can still be avoided by a (shadow) director who can demonstrate that from that point in time onwards he/she took every step with a view to minimizing loss to the company's creditors as he/she ought to have taken. The threshold for successfully invoking this defense is high and also features an objective as well as a subjective standard.

DUTY TO CONTRIBUTE¹²

If the 'no reasonable prospect' requirement is met, but the directors continue to trade and are unable to rely on the 'every step' defense, then the Court has discretion to determine, as it thinks proper, the contribution a director must make based on wrongful trading liability. The starting point for determining the required contribution is that there must

⁹ According to *Sealy & Milman: Annotated Guide to Insolvency Legislation 2017* (20th edition), Volume 1, commentary to Section 212(1) IA 86, p. 220, the better view is that shadow directors are not within Section 212 IA 86 for a misfeasance claim.

¹⁰ See in particular Sections 2.4 and 2.5 of this report.

¹¹ See in particular Sections 2.6-2.8 of this report.

¹² See in particular Section 2.9 of this report.

be an increase in the net deficiency of the company which reflects the loss to the company as a result of the commencement of the liquidation/administration proceedings being delayed. The contribution is compensatory in nature, rather than penal.

ESSENTIAL PRACTICALITIES¹³

So what should directors in the zone of insolvency do? Although not a shield for directors' liability, English Courts do place some reliance on independent professional (specialist insolvency) advice directors have obtained. It is therefore prudent for directors to timely involve specialist advisors, both financial and legal. When in or close to the zone of insolvency, it is further prudent for directors to keep a detailed written record and hold regular full board meetings to consider the company's financial position with detailed minutes reflecting discussions, options considered, plans, projections, assumptions and providing fully reasoned explanations for decisions made.¹⁴

Peter J.M. Declercq

London, 28 November 2017

13 See in particular Sections 2.6 and 4.2(e) of this report.

14 For a list of other adequate and appropriate steps directors in the zone of insolvency may, depending on the facts and circumstances of the situation at hand, wish to consider, see UNCITRAL Judicial Guide, *supra* note 1, Chapter II (Elements of directors' obligations in the period approaching insolvency) at para. 5.