

Directors' liability: what should be the minimum harmonisation in the EU?

Róbert Muzsalyi

Moving the centre of main interests (hereinafter: COMI) from one Member State to the another may have a significant impact on both the extent and the content of the directors' duties and liabilities, as well as on the enforcement of these duties. This situation could result in uncertainty for the creditors and the directors alike. In my view, these difficulties could be resolved by the minimum harmonisation of the directors' duties. The issue that I want to focus on refers to what could be the starting point for the common rules.

In the first part of my paper, I will analyse by a fictional case study the rules concerning the directors' duties in various Member States, and the changes in liability when a company becomes insolvent or comes close to it.

In the second part, I will analyse the main characteristics of the procedures for establishing the liability of the directors (under what conditions and who can bring a claim).

In the third part, I will summarize the differences and similarities of these rules and attempt to define the minimum standards for the EU harmonisation.

The problems encountered in the practical application of the European Insolvency Regulation (EIR)¹ show that the cross-border regulation is not sufficient. The differences between the national insolvency laws remain a considerable obstacle to the unified and effective application of the cross-border insolvencies. Following the Recast EIR² the reform has not finished. The Commission has issued a Recommendation to the Member States on a preventive restructuring framework and the Commission intends to issue a legislative initiative during 2016 on insolvency reform, with the purpose of harmonising the insolvency regimes of the Member States.

I. Case study³

The debtor company was in active production and it was assembling electrical goods in Germany. The materials used for the production were imported from East European countries, mainly from Hungary. The debtor got into a state of impending insolvency, because it was not able to pay its debts as they fell due. After this happened, Mr. Grenbuch, the director of this company, made unlawful payments to his family members out of the assets of the company totally in EUR 50,000.

The shareholders considered the difficult economic situation of the company and decided to move the COMI to Budapest, because they could rent property and machines at a considerably lower price in Hungary. Moreover, the company would be closer to its suppliers. Thus, they could reduce the transportation cost, as well.

The company - managed by Mr. Grenbuch – started to operate in Hungary, however, it was still it was unable to pay its bills on due time. Consequently, upon the request of a Hungarian

¹ Council Regulation (EC) 1346/2000 of May 2000 on insolvency proceedings, hereinafter: EIR.

² Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast) hereinafter: recast EIR.

³ This case is fictional. However, I think that the situation and the events cannot be considered untypical and detached from reality.

creditor, the Budapest Regional Court established the debtor's insolvency, ordered its liquidation and appointed a liquidator.

After the liquidator had examined the debtor's accounts and payments, he brought a claim against Mr. Grenbuch to establish that he had failed to properly represent the interests of the creditors in the span of three years prior to the opening of liquidation proceedings in the wake of any situation carrying potential danger of insolvency, when he had made unlawful payments to his family members in Germany.

Mr. Grenbuch objected to the jurisdiction of the Hungarian court. He argued that he was a German director of a German company, when he had made the questioned payment, he had been under the German law, and therefore he considered the provisions of the German law should apply, not the Hungarian ones.

Problems raised by the study case:

- a) Which court has jurisdiction for the directors in case of COMI shifting?
- b) Which Member States law will apply?
- c) Could the Hungarian court examine the validity of payments made in Germany or only those made when the COMI was in Hungary?

II. Same unlawful conduct but different decision depending on the applicable law

Hungarian law follows the “wrongful trading” strategy: there is a shift of director's duties, which prioritizes the interests of creditors when the company is in potential danger of insolvency.⁴ The duties of the director who has managed the company during the three years prior to the opening of liquidation proceedings⁵ will be examined in court. In Hungary, there is no “duty to file” when the company is insolvent. Moreover, the director cannot file an application for the opening of liquidation proceeding without the shareholders' decision.

Hungarian law provides for a two-stage procedure. Firstly, under the liquidation procedure, the court can establish the liability of directors. Secondly, subsequent to the delivery of a final judgment establishing the liability of the directors and the final conclusion of liquidation proceedings, any creditor may bring an action to the extent of its claims not yet satisfied. If the directors fail to effect the payment obligation contained in this final decision (and only in such a case), the court could disqualify them for five years.⁶

German law follows the “duty to file” strategy, which means that the director shall apply for the opening of insolvency proceedings without material delay, and at the latest within three weeks after a company becomes illiquid or over-indebted.⁷ A company is illiquid when unable

⁴ A situation is considered to carry potential danger of insolvency as of the day when the directors of the company were or should have been able to foresee that the company will not be able to satisfy its liabilities when due.

⁵ Act XLIX of 1991 on reorganisation and liquidation procedures (hereinafter: HRLP.) section 33/A.

⁶ The disqualified director shall not acquire majority control in any business association, shall not be installed as a member with unlimited liability in any business association or as a member of a sole proprietorship, and shall not be a director of any company. The disqualification period in every cases is five years. Act V of 2006 on Public Company Information, Company Registration and Winding-up Proceedings Section 9/B.

⁷ Insolvency Statute of 5 October 1994 (hereinafter: InsO) Section 15a.

to meet its mature obligations to pay. A company is overindebted if its assets no longer cover its existing obligations to pay, unless it is highly likely, considering the circumstances, that the enterprise will continue to exist.⁸ Under German law, liability for delaying insolvency proceedings results from the culpable violation of the duty to file formal insolvency proceedings. Directors who culpably (intentionally or negligently) fail to file insolvency proceedings commit a delict and will be personally liable for any damage caused.⁹ The claim for damages resulting from this liability is barred until insolvency proceedings are closed. At this point, it is possible to take into account any compensation already awarded and to establish whether the claim against the director was settled by the administrator or liquidator.¹⁰

The disqualification causes are regulated in statutes on the various forms of companies (GmbHG, AktG etc.), which require some form of criminal conduct committed by the director as a precondition to disqualification. This includes bankruptcy, aggravated bankruptcy, violation of book-keeping duties, extending unlawful benefits to creditors, and extending unlawful benefits to debtors.¹¹ In the above case study, Mr. Grenbuch's conduct would constitute "bankruptcy" (Bankrott), a crime under §283 of the German Criminal Code.¹²

III. Cross-border liabilities for the breach of duties

Actions against the directors for breach of their insolvency-related duties are clearly categorised by the CJEU as belonging to insolvency law rather than company law.¹³ The main difference lies in the aim of the provisions: company law protects the company and its shareholders, while insolvency law protects third parties, mainly the creditors.

The courts of the Member State, within the territory of which the centre of a debtor's main interests is situated, shall have jurisdiction to open insolvency proceedings.

The CJEU had previously held that the effectiveness Article 3(1) of EIR, must be interpreted as meaning that it confers international jurisdiction on the Member State within the territory of which insolvency proceedings were opened in order to hear and determine actions which derive directly from those proceedings and which are closely connected to them.¹⁴ In another case, the

⁸ InsO Section 17 (2), 19 (2). This provision was amended in 2008 as a reaction to the global financial crisis. This new concept of over-indebtedness was intended to apply only temporarily, until 31.12.2013 but was re-instated and it continues to apply. Before the amendment, a company was considered overindebted also if its assets, taken into account on a going concern value, did not cover its existing liabilities. See more details: Bernd Meyer-Loewy: Germany. In: *Directors in the Twilight Zone IV. INSOL International*, 2013. 189.

⁹ *Directors' liability for conduct in the vicinity of insolvency (2009)* in: Thomas Bachner: *Creditor Protection in Private Companies: Anglo-German Perspectives for a European Legal Discourse*. Cambridge University Press, 180–247.

¹⁰ Susanne Kalss – Nikolaus Adensamer – Janine Oelkers: *Director's Duties in the Vicinity of Insolvency – a comparative analysis with reports from Germany, Austria, Belgium, Denmark, England, Finland, France, Italy, The Netherlands, Norway, Spain and Sweden*. In: Marcus Lutter (ed.): *Legal Capital in Europe*. De Gruyter Recht, Berlin, 2006. 115, 118.

¹¹ Heribert Hirte – Tim Lanzius – Sebastian Mock: *Directors' disqualification and creditor protection*. In: Marcus Lutter (ed.): *Legal Capital in Europe*. De Gruyter Recht, Berlin, 2006. 257.

¹² (1) Whosoever due to his liabilities exceeding his assets or current or impending inability to pay his debts disposes of or hides, or, in a manner contrary to regular business standards, destroys, damages or renders unusable parts of his assets, which in the case of institution of insolvency proceedings would belong to the available assets; (...) shall be liable to imprisonment not exceeding five years or a fine. German Criminal Code Section 283.

¹³ Kornhaas judgment, C-594/14, EU:C:2015:806.

¹⁴ Seagon judgment, C-339/07, EU:C:2009:83, paragraph 21.

CJEU has stated that the actions brought by the liquidator in the insolvency proceedings against the managing director of a company for reimbursement of payments made after the company had become insolvent, derive directly from the insolvency proceedings and are closely connected to them.¹⁵

In a recent case, *Kornhaas*, the CJEU has pointed out that the law of the main proceeding also determines the applicable law for the director's liability (the extent and also the enforcement of the liability), notwithstanding the fact that the debtor and the director are located in another Member State. The CJEU has also mentioned the main targets of the directors' insolvency-related duties in the national legislation. These provisions contribute to the attainment of an objective which is intrinsically linked to all insolvency proceedings, namely the prevention of any reduction of the insolvent estate before the insolvency proceedings are opened, so that the claims of all the company's creditors may be satisfied on equal terms to the maximum extent possible.¹⁶

By the shifting of debtor's COMI, the applicable provisions for director's duties also change; consequently different law will be applicable for the enforcement of their liability.

Due to the different regulation in Member States, it can easily happen that a permissible act committed in one Member State, is not sanctioned in another, or conversely, is more seriously sanctioned.

Consequently, the liability of directors could be established under the law of a Member State, which they did not take into account when the questioned conduct was committed.

The directors may not have any influence on the COMI shifting, because this may be a shareholders' decision (except in cases where the director is also the majority owner of the company). By shifting of the debtor's COMI, the related provisions on director's duties also change. Hence, a different law will be applicable to the enforcement of their liability.

With the change of the COMI, the directors have to acknowledge that under the new Member State's law, they may have different duties and liabilities than previously. If they do not accept this risk, they could resign obliging the shareholders to appoint a new director.

However, in certain cases, the director is not exempted from the liability with this resignation. Under several Member States' jurisdiction, the courts examine the conduct of those directors who managed the company during the three years prior to the opening of liquidation proceedings. Consequently, the courts would examine the conduct of the resigned directors if they managed the company in the three-year period. Moreover, in my opinion the duties have to be examined under the new Member State's law (in accordance with the *Kornhaas* decision) and directors would be held liable for the breach of these duties.¹⁷

It would totally contradict the CJEU case law, if the courts which have jurisdiction to open insolvency proceeding, and therefore have jurisdiction for any action against the directors

¹⁵ H v H. judgment, C-295/13, EU:C:2014:2410, paragraph 26.

¹⁶ *Kornhaas* judgment, EU:C:2015:806, paragraph 20.

¹⁷ In the English case law it has been held that liability for wrongful trading applies also to directors of foreign companies: *Re Howard Holding Inc [1998]* BCC 549. The court can also disqualify a foreign director of a foreign company and can order service abroad: see *Re Seagull Manufacturing Co Ltd (No 2) [1994]* Ch 91. Under the Companies Act 2006 ss 1182-1191, regulations can be made for disqualifying directors subject to foreign disqualifying restrictions and making them liable for the debts of the company. See more details: Philip R Wood: *Conflict of Laws and International Finance*, Sweet & Maxwell, 2007, 21-034.

(because this derives directly from the insolvency proceeding and is closely connected with them) would have to apply the law of another Member State on the directors' liability.

Nor would it suit the above mentioned targets if a court had jurisdiction for the main proceeding but it did not have jurisdiction for any actions against the resigned directors, obliging the liquidator to sue the directors in different Member States, depending on whether they were managing the company before or after the COMI shifting. I do not think that it would be feasible and effective if the liquidator had to bring a claim under the law of a different country.

IV. The corner points of the harmonisation

First of all, the director's liability for the insolvency related duties should be clarified as related to the liquidation proceeding. In the case of reorganization proceedings, the creditors could pursue a claim against the debtor, and the debtor could sue the directors for the breach of duties specified under the company law. So I attempt to define the corner points of the harmonisation in the context of liquidation.

In several cases, the harmonisation should mean codifying the CJEU case-law. The national provisions for the director's liability are internally fragmented in the law of the Member States. They are specified in insolvency law, civil law, company law, tort law etc. There are Member States where the liability also differs according to the company forms. Therefore, firstly it should be clarified that the director's duties to creditors are related to insolvency law, not to company or tort law.

4.1 Insolvency-related duties

In the European Union, there are two main types of jurisdiction depending on the insolvency-related duties of the directors. Some Member States use the "duty to file" strategy. Under this approach, directors are obliged to apply for the opening of insolvency proceedings within a certain period if the company reaches certain pre-defined insolvency triggers and typically after this situation they are not allowed to make any payments.

Other Member States use the "wrongful trading" strategy. In these jurisdictions there is a shift of the director's duty of care when the company is in the vicinity of insolvency and there is no duty to file for the opening insolvency proceedings to the court.¹⁸ In this situation, the directors have to properly represent the interests of creditors rather than the interests of the company or the shareholders.

As Professor Keay pointed out, these differences do not mean that in Member States where a director's duty does not shift on the advent of the vicinity of insolvency, directors are free to do whatever they like. These Member States have a provision which is designed to achieve similar aims. The "*Beklamel-rule*" in Netherlands and the "*action an comblement du passif*"

¹⁸ There are eight jurisdictions in which a shift is seen: Cyprus, Denmark, Estonia, Hungary, Ireland, Latvia, Malta and the UK. Carsten Gerner-Beuerle – Edmund-Philipp Schuster: The Evolving Structure of Directors' Duties in Europe. (2014) Vol. 15. European Business Organization Law Review, 224.

in France are cited as examples that these jurisdictions provide that directors can be held liable for a form of wrongful trading.¹⁹

As I mentioned in the case study (chapter I), it may cause significant problems if a company changes its COMI from a “duty to file” strategy country to a “wrongful trading” country or vice versa. These differences lead to legal uncertainty, which makes European harmonisation necessary. In the light of the above, my opinion is that the two main strategies do not preclude each other; moreover, they could complement each other at the European level. Thus, the starting point of the harmonisation should not be to have to select one of these strategies or find a new one. The EU ought to provide guidance for the definition of the vicinity of insolvency and the insolvent status of a company and make clear that the directors should take their responsibilities and act prudently in both situations.

4.2 Procedure rules

Those minimum procedural rules should be determined which are necessary to ensure the effective judicial proceeding will result in the recovery by the insolvency estate of the wrongfully paid amount.

It should be defined that these actions could be brought only before the court which made the insolvency order; that only the insolvency practitioner can bring the action; and that they can only be brought during the liquidation proceeding. These elements are particularly important because of the availability of the necessary evidence and the professional competence of the insolvency judges.

It should be defined who can bring the action in such a way that the wrongfully paid amount is recovered by the insolvency estate in every case. The insolvency practitioners are best suited to this task, because they have the appropriate competence and information of every transaction made before the opening of liquidation and the legal authority to compel the production of evidence.

4.3 Disqualification

Moreover, establishing the liability of directors for breach of insolvency-related duties may result in the directors being sanctioned by disqualification too.

Almost every Member State has disqualification rules for directors, and only a few Member States do not have a central public register of the disqualified persons.²⁰ The comparative legal analysis has also shown that the Member States’ provisions may differ according to the time

¹⁹ Andrew Keay: “The Shifting of Directors’ Duties in the Vicinity of Insolvency” (2015) 24 *INSOL International Insolvency Review*, 150. For more details see: Andrew Keay: *Company Directors’ Responsibilities to Creditors*. Routledge-Cavendish, 2007, 79.

²⁰ Only Greece and Italy doesn’t exist the disqualification proceeding and there is other eight Member States (Austria, Belgium, Cyprus, Denmark, Germany, Netherlands, Slovakia, Slovenia) which do not have public register. Gerard McCormack – Andrew Keay – Sarah Brown – Judith Dahlgreen: *Study on a new approach to business failure and insolvency. Comparative legal analysis of the Member States’ relevant provisions and practices*. Table 1.4. Disqualification Regimes 65-69.
http://ec.europa.eu/justice/civil/files/insolvency/insolvency_study_2016_final_en.pdf (downloaded: 06/09/2016)

period, the content and the reasons for disqualification. However, with very few exceptions, disqualification is one of the main sanctions for the breach of insolvency-related duties.²¹

The disqualification objectives should be effective not only at the national level, but throughout the EU. Sanctions connected to the breach of insolvency-related duties protect the companies and creditors and they also have a deterrent effect. The lack of the harmonisation of this field undermines the national protection, because according to the rules in force, there is no obstacle for a disqualified director to manage a company in a different Member State. The lack of availability of information about the disqualified persons ensures the free movement of the reckless and dishonest directors who could cause potential business failures in other Member States. For example, a director who was disqualified under Hungarian law cannot manage a company in Hungary for five years, but he could act as a director in Germany or any other Member State.

The rules in force do not ensure the availability of information on the disqualified directors. Under the recast EIR article 24.3 Member States have an opportunity to share and receive this information (more precisely they are not precluded from doing to), but they are not obliged to ensure access to such information.

It is also not clear whether a national disqualification order automatically extends to other Member States, so the EU should provide for the mutual recognition of disqualification orders.

V. Closing remarks

The existing insolvency regimes in the Member States are very different mainly for traditional reasons. The full harmonisation of every part of the insolvency law is not possible and not necessary. However, there are fields where the lack of harmonisation leads to legal uncertainty and in certain cases undermines the aims of the national provisions.

The Member States' provisions for director's liability and its interpretation by the courts are functioning well, or at least they do not cause significant uncertainties at the national level. The difficulties arise when a company with its director moves from the national level and these well-functioning national provisions cause surprises and legal uncertainty at an international level. I think the minimum harmonisation is particularly important where this kind of surprise easily arises.²² A company that shifts its COMI from a country with a duty to file strategy to another which follows the wrongful trading strategy (or vice versa) is a situation that could cause surprises in the field of director's liability. These difficulties could be resolved if the main points of these strategies namely "the vicinity of the insolvency" and the "insolvent status" of the debtor are clearly defined at the EU level or at least offer sufficient guidance for the courts.

Moreover, the lack of harmonisation also undermines the aim of the national provisions on disqualification. For a disqualified director, there is no obstacle to prevent them managing a

²¹ Sørensen, KE (2013), *Disqualifying Directors in the EU*. In HS Birkmose, M Neville & KE Sørensen (eds), *Board of Directors in European Companies: Reshaping and Harmonising Their Organisation and Duties*. Kluwer Law International, Alphen aan den Rijn, 333.

²² For the definition of the „surprise effect” in the context of the European civil law harmonisation see: Thomas Kadner Graiziano: *Le futur de la Codification du droit civil en Europe: harmonisation des anciens Codes d'un nouveau Code?* In: Jean-Philippe Dunand – Bénédicte Winiger (eds): *Le Code civil français dans le droit européen*, Bruxelles: Bruylant, 2005, 258-259.

company in another Member State. Accordingly, a register at the EU-level, or access to this information for the national authorities of another Member State would also be necessary.