Directors' liability: What should be the minimum degree of harmonisation in the EU?

Róbert Muzsalyi presents a fictional case study on the impact of COMI shifting on directors' duties

Moving the centre of main interests (hereafter, 'COMI') from one Member State to another may have a significant impact on both the extent and the contents 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 a minimum degree of harmonisation regarding the directors' duties. The issue that I want to focus on refers to what could be the starting point for the common rules.

Case study

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, totalling €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 unable to pay its bills on time. Consequently, upon the request of a Hungarian 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 payments, that he had been under the German law, and therefore he considered the provisions of the German law should have applied, not the Hungarian ones.

Róbert Muzsalyi (centre) receiving his award at the Annual Congress Gala Dinner, held at the 'Estufa Fria' in Central Lisbon's Edward VII Park

Problems raised by the study case:

a) Which court has jurisdiction for the directors in case of COMI shifting?
b) Which Member State's 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?

Same unlawful conduct but different decision depending on the applicable law

Hungarian law follows the "wrongful trading" strategy: there is a shift of the director's duties, which prioritises the interests of creditors when the company is in potential danger of insolvency.

The duties of the director who has managed the company during the three years prior to the opening of liquidation proceedings 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

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This is the first time that we have had a winner from Hungary. Previous winners have come from Uganda, Belarus, India, Latvia, Lithuania, Poland, PRC, Romania, Russia and Serbia.

Róbert was invited to the Annual Congress in Lisbon to receive his award.

An abbreviated version of his award winning paper is presented here. The full version and further information about the award can be found on line at www.insol-europe.org/richard-turton-award

IN HUNGARY, THERE IS NO "DUTY TO FILE" WHEN THE COMPANY IS INSOLVENT... GERMAN LAW FOLLOWS THE "DUTY TO FILE" STRATEGY

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.

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. 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. 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.

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. In the above case study, Mr.Grenbuch's conduct would constitute "bankruptcy" (*Bankrott*), a crime under §283 of the German Criminal Code.

Cross-border liabilities for the breach of duties

The Court of Justice of the European Union (hereinafter: 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[1].

The CJEU has stated that the actions brought by the liquidator in the insolvency proceedings against the managing director of a company, derive directly from the insolvency proceedings and are closely connected to them[2].

In the recent *Kornhaas* case,[3] the CJEU has pointed out that the law of the main proceedings 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 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 the shifting of the debtor's COMI, the related provisions on the director's duties also change. Hence, a different law will be applicable to the enforcement of their liability.

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.

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 the directors would be held liable for the breach of these duties.

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 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 proceedings but it did not have jurisdiction for any actions against the resigned directors, obliging the liquidator to sue the directors in a different Member State, 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.

The most important points of harmonisation

Insolvency-related duties

In the EU, 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 of opening insolvency proceedings to the court. In this situation, the directors have to properly represent the interests of creditors rather than the interests of the company or the shareholders.

As I mentioned in the case study, it may cause significant problems if a company changes its COMI from a country following the "duty to file" strategy to a one where "wrongful trading" is the rule, or

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vice versa. These differences lead to legal uncertainty, which makes European harmonisation necessary. My opinion is that the two main strategies do not preclude each other; moreover, they could be complementary to 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.

Procedure rules

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

It should be also defined who can bring the action. The insolvency practitioners are best suited to do this, because they have the appropriate competence and information about every transaction made before the opening of the liquidation proceedings and the legal authority to impose the production of evidence.

Disqualification

Establishing the liability of the directors for breach of insolvency-related duties may result in the directors being also sanctioned by disqualification.

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. ■

DISQUALIFICATION OBJECTIVES SHOULD BE EFFECTIVE NOT ONLY AT THE NATIONAL LEVEL, BUT THROUGH-OUT THE EU

Footnotes

1 Seagon judgment, C-339/07, EU: C: 2009: 83, p.21
2 HvH. judgment, C-295/13, EU: C: 2014: 2410, p.26.
3 C-594/14, EU: C: 2015: 806.

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Richard Turton had a unique role in the formation and management of INSOL Europe, INSOL International, the English Insolvency Practitioners Association and R3, the Association of Business Recovery Professionals in the UK. In recognition of his achievements these four organisations jointly created an award in memory of Richard. The Richard Turton Award provides an educational opportunity for a qualifying participant to attend the annual INSOL Europe Conference.

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