Wrongful trading in Europe

Mihai Lanţoş looks into Western, Central and Eastern European directors' liability systems whilst they also prepare for a new EU Directive on insolvency

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All modern European systems of law in force today provide for some sort of liability system for directors of companies, triggered by situations related to insolvency.

If in some cases the obligations of the directors or the liability cases are loosely defined (holding the directors liable if general duties are disregarded), other pieces of legislation provide detailed and specific situations for misconduct leading to personal liability.

The present article undertakes to briefly analyze three of Europe's jurisdictions in this regard, looking into the common-law system of the UK, the high performance statutory law system of Germany and Romanian – one of Europe's most insolvency active jurisdictions, thus covering Europe from west to east. At the same time, the new development in EU legislation will be taken into account.

In the EU, the issue of the directors' duties plays an important role when it comes to insolvency. Article 18 of the EC proposed Directive on restructuring frameworks underlines the most common and widespread obligations of the directors in most European jurisdictions. This article defines the conduct the directors must have, putting together the general duties and those normally seen only in insolvency situations.

The general duties would be:

- taking reasonable steps to avoid insolvency; and
- avoiding deliberate or gross negligent conduct which threatens the viability of the company.

> **IN THE EU, THE ISSUE OF THE DIRECTORS' DUTIES PLAYS AN IMPORTANT ROLE WHEN IT COMES TO INSOLVENCY**

The specific duties in case of insolvency are:

- the obligation to take immediate steps in order to minimise loss (damage) for the creditors, workers, shareholders and other stakeholders; and
- the obligation to have due regard to the interests of the creditors and other stakeholders.

Section 5 of the Explanatory Memorandum on the EC draft Directive establishes that Article 18 should present an incentive for the directors to pursue early restructuring when the company is still viable (i.e. pursue a *safeguarding approach as opposed to winding-up*).

Article 18 of the EC proposed Directive bears a striking resemblance to Article 214 of the UK Insolvency Act of 1986 which defines "wrongful trading" under UK law. Although Article 18 of the draft Directive is broader and somewhat imprecise, it is similar in nature and interpretation to the above mentioned UK Article 214. Both articles describe the consequences of the actions of the directors in case of imminent insolvency and seek to determine the directors to act so that insolvency is avoided and, should insolvency be reasonably unavoidable, to aim at limiting the damage to creditors (stakeholders) of the company.

This provides for a shift of focus in the directors' duties when insolvency is imminent. If up to this point the directors had duties of a fiduciary nature towards the company, when insolvency is imminent they will have to safeguard the interests of the creditors (and other stakeholders), even if this would infringe the shareholders' interests.

UK: Every step

Under UK law the most commonly used defense of directors is the "*every step*" notion provided in section 214 par. (3) of the Insolvency Act of 1986, which provides for relief for those directors who, realising insolvency is imminent, took "*every step*" reasonably leading to safeguarding the creditors' interests by either avoiding insolvency or by minimising the potential losses where insolvency could not be avoided.

Such conduct should be based on the directors' diligent conduct towards the company's situation, meaning that they have to keep updated about the company's financial and economic situation and act accordingly.

In the past, case-law[1] has sanctioned the conduct of negligent directors who relied on "*speculative hopes*" that the situation of the company would turn itself around, rather than act on the basis of "*rational expectations of what the future might hold*".

The most recent case-law[2] outlined a more accessible "*every step*" defence, stating that directors cannot be held liable if they take professional advice and apply that advice once the situation changes. Such an approach is based on the "*high hurdle for directors to surmount*" presented by every step which should be taken to avoid damages towards creditors. Nonetheless, wrongful trading under the UK

law is based on the breach of the reasonably diligent conduct of directors in safeguarding the creditors' interests in case of imminent insolvency.

Germany

Germany, one of the high-performance insolvency jurisdictions in Europe, has adopted a somewhat different approach, but one which still derives from the same general principles of safeguarding creditors' interests. The two main laws that commercial companies are concerned with are the *Aktiengesetz (AktG)* and *Gesetz für Gesellschaften mit Beschränkter Haftung (GmbHG)*. These provide distinct rules for public limited companies and limited liability companies, but both define the directors' duties. Section 43 paragraph (1) of GmbHG prescribes the obligation for directors to act in good-faith and as diligent businessmen. Section 93 of AktG gives more detailed elements for the directors' duties, which are to act in accordance with the law, the articles of the association and the decisions of the shareholders, so that the interests of the company as a whole should always remain a beacon for any of the directors' actions.

The *Insolvenzordnung (InsO)*, the German insolvency law, provides for a limited number of situations in which the directors' liability can be triggered. First and the most direct, section 15a of the InsO sanctions directors for "*Insolvenzverschleppung*", i.e. not filing for insolvency within 3 weeks of the setting in of *Zahlungsunfähigkeit* (inability to pay outstanding debt) or *Überschuldung* (overindebtness). Such misconduct is also sanctionable under section 823 par. (2) of the "*Bürgerliches Gesetzbuch*" (the German Civil Code). This section provides that a person can be held liable in case it fails to uphold legislation put in place for the protection of others.

Chapter 9 of *InsO* outlines the situations in which a debtor (i.e. directors) can obtain relief from unsettled debt and an under-section provides reasons for which the court may deny relief to the debtor company and the directors. A quick walk through these provisions outlines a general duty of the directors to act in such a way that the creditor's interests are safeguarded before or during an insolvency procedure[3], thus providing conditions resembling Article 18 of the EC draft Directive and the UK wrongful trading provisions. Also relevant in regard to liability of directors are the *Insolvenzstraftaten* (criminal conduct related to insolvency) prescribed under sections 283 – 283d of the German *Strafgesetzbuch (StGB)*, the German Criminal Code. Under these regulations, directors can be sanctioned with personal liability and criminal punishment for actions which lead to damages incurred by the company or the insolvency procedure (such as failure to keep records or reckless conduct of business). The widespread *business judgement rule* can be seen when analysing these provisions as a whole. Courts of law in Germany have time and again concluded that directors may not be so clairvoyant as to know the outcome of a business venture beforehand, but they have an obligation to act with care and always keep informed in regard to the situation of the company, so that they make decisions based on proper information.

Romania

Romania, one of the most insolvency-active jurisdictions of Eastern Europe, has codified the directors' liability in its companies act (Law No. 31/1990), as well as in its Insolvency Act (Law No. 85/2014). Section 114[1] of the Companies Act introduces the *business judgment rule* which is to be used in all decision-making processes in a company and during their implementation. Section 169 of the Romanian Insolvency Act of 2014 is much more creditor-oriented. In case the actions of a director (detailed under section 169) lead to insolvency, official receivers or even creditors have the opportunity to submit claims in courts of law so that the directors will be personally liable for debt unrecoverable from the insolvent company. Directors can be held liable for actions such as failure to keep records in accordance with the law, personal use of companies' assets and/or credit, preferential payment of creditors, etc. This approach indicates what the Romanian legislator considered to be the *wrongful trading* of Romanian directors. Although conditions for triggering liability under section 169 are limited to specifics described thereunder, the 2014 addition of paragraph (2) in this section allows for liability actions to be taken in all instances where the actions of the directors or third parties have led to insolvency.

Conclusion

Every one of the three jurisdictions mentioned above uses rules and conditions for liability developed over the course of its own legal history. These approaches are somewhat different but they all follow a principle rule that provides for triggering liability of companies' directors in case of *wrongful trading*. The term, however, is defined differently under each jurisdiction. The EU draft directive extracts the essence of *wrongful trading* which can be recognised throughout all three jurisdictions, making trading within the EU more predictable. ■

Footnotes:

1 *Ward v Perks, Re Hawks Hills Publishing Company Ltd (in liquidation) [2007]* and, more famously *Earp v Stevenson, Re Kudos Business Solutions Ltd (in liquidation) [2011]*

2 *Ralls Builders Limited (in liquidation) [2016]*

3 For example, section 290 par. (1) pt. 4 denies relief for directors who intentionally or gross-negligently postponed filing for insolvency, thus affecting the possibility of creditors' claims to be settled.

> **THE EU DRAFT DIRECTIVE EXTRACTS THE ESSENCE OF WRONGFUL TRADING WHICH CAN BE RECOGNISED THROUGHOUT ALL THREE JURISDICTIONS**

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