Luxembourg: Out of the frying pan and into the fire?

Christel Dumont examines the liability of directors when groups of companies fail

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“A DIRECTOR HAVING SEVERAL MANDATES IN THE SAME GROUP OF COMPANIES MAY BE IN AN UNWORKABLE SITUATION AS THE CORPORATE INTERESTS OF THE GROUP MAY NOT COINCIDE”

This is no doubt about it, being a director in a company facing difficulties is a complex and dangerous task, but one notch higher in the danger stakes is being a director of several companies belonging to the same group facing difficulties.

Directors are often in the middle of a power game between various stakeholders, whether they are creditors or shareholders, who nowadays have no hesitation in putting pressure or even in suing them to have them held liable for breach of their fiduciary duty. In this context, a director having several mandates in the same group of companies may be in an unworkable situation as the corporate interests of the various entities of the group may not coincide.

Duties and liabilities of directors are mainly governed under Luxembourg law by the law dated 10 August 1915 on commercial companies as amended (“Company Law”) and by several provisions of the civil, commercial and criminal codes.

The notion of group of companies is not unknown under Luxembourg law, especially in labour law, accounting law or in the law dated 2 September 2011 regarding business licenses[1]. However, even if the notion has been defined in these legal provisions, the notion of group in itself does not have consequences and there are no specific provisions regarding groups of companies in the Company Law. The corporate interest of the group is not recognised as such in the Company Law and even if a notion of group exists, each company belonging to that group would still be considered as an independent legal entity from a corporate law perspective.

In the context of insolvency, in a pure national situation, the commercial court would consider each separate legal entity and would check whether or not the two cumulative conditions of bankruptcy are met which in practice would usually be the case for all the entities even if they are considered individually.

The proposal for a regulation of the European Parliament and of the Council amending Council Regulation (EC) 1346/2000 on insolvency proceedings (“Proposal amending the EIR”) is an important step and in a cross-border context, the notion of group of companies may be dealt with differently in the future. The Proposal amending the EIR explains that the evaluation of the EIR has identified five main shortcomings among which the insolvency of groups. Indeed, the EIR "*does not contain specific rules dealing with the insolvency of a multi-national enterprise group although a large number of cross-border insolvencies involve groups of companies*". The same applies as in a national context, i.e. separate proceedings must be opened for each entity of the group and "*these proceedings are entirely independent of each other*"[2]. The Proposal amending the EIR provides for a coordination of the insolvency proceedings concerning different members of the same group of companies by obliging the liquidators and courts involved to cooperate and communicate. The liquidators involved will also have the procedural tools to request a stay of the respective other proceedings and to propose a rescue plan for all the members of the group. This would certainly significantly provide a better approach to this type of insolvencies. The fact that the liquidators will be able to exchange relevant information and to coordinate with each other raises the question whether such increased cooperation could also increase the risk of liability for directors of several entities of the group.

Personal liability

Under Luxembourg law, in most bankruptcies, the directors are generally not personally bound by the decisions they make or have made, that is, if these decisions have been taken honestly, in the best interests of the company, and if they have a minimum standard of competence, the company is bound by their decisions even though such decisions might have led to the bankruptcy of the company.

It is nevertheless possible to look beyond the separate entity of the company and its corporate body and hold directors personally liable for their actions. A court may decide to extend the bankruptcy of the company to its directors. The rationale behind this principle is to prevent fraud. In this respect, the company's debts are merged with those of the director who has acted in his own interest. Article 495 of the Luxembourg commercial code envisages this when a director for example has undertaken commercial transactions for his own personal interest or has used the property of the company as his own property, or has improperly continued to work in his own interest with an operating deficit which could only result in the company suspending all of its payments.

This typically applies to directors who abuse their majority position in the company and direct the company in their own personal interest and are quite rare situations in group structures.

Serious and blatant fault

What could be more relevant in the context of a group facing difficulties is the action to bridge insufficient assets ("*action en comblement de passif*") provided for by article 495-1 of the commercial code. According to this article, if there are insufficient assets, the Commercial Court can decide on a motion that any shortfall in company assets is to be completed from the personal assets of the directors if they have committed a serious and blatant ("*caractérisée*") offence leading to the bankruptcy. The Court may condemn directors to contribute, wholly or partially, jointly or individually, to cover the deficit, under the condition that their serious misconduct has led to the company's bankruptcy.

A serious and blatant fault is seen as the act or the omission that has a causal link with the bankruptcy and of which the director was aware, or could not have been unaware that it could cause the bankruptcy. Such a fault, therefore, implies the concept of "*dol*" which is intentional fault or fraudulent gross negligence ("*faute dolosive*"). The fault becomes blatant if it surpasses the margin of error allowed under the circumstances.

Of course, examples in practice do not seem to apply in the context of a group as for example it has been held that a complete lack of awareness of or of diligence to the company's affairs constitutes a blatant fault. If directors failed in their duty to draw up annual accounts as envisaged by the Company Act, and there is evidence that this contributed to the insolvency, then this might also constitute such a blatant fault. Again, this is usually not the case in the context of insolvency of international groups of companies with several companies in Luxembourg.

It is however interesting to note that a serious and blatant fault could exist when directors intentionally or negligently incur debts while the company is insolvent or has no hope of being able to pay. In this last example, where the corporate interests of the various entities of the group are not the same, the directors, if they have several mandates for these various entities, may know that a specific company of the group has no hope of being able to pay. For example, the company has a subsidiary which is already insolvent but the directors may still incur debts in order to save other entities of the group. Obviously, there is no precedent yet and it must be proved that they have acted intentionally or negligently, which might still be difficult to prove but it cannot be entirely excluded.

In addition, it is important to note that the Luxembourg government filed a new bill of law (Bill n°6539, the "Bill") on the protection of undertakings and the modernisation of insolvency law on 1st February 2013. The Bill particularly intends to simplify the criminal provisions in order to allow easier prosecution. In this context, the amendment of article 495-1 may increase the potential liability of directors. Indeed, the current wording of the Bill intends to replace the notion of "*serious and blatant fault*" by the notion of "*management fault*" having contributed to insufficient

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assets. Such an amendment would indeed increase the stringency of the law and could increment the potential liability of directors as this can result in an extensive interpretation of the notion of "*management fault*" by the Courts. But, the Bill does not define what should be considered as a "*management fault*" and judges may be tempted, depending on the circumstances, to make an extensive interpretation of the notion.

EU study

The European Commission has not to date considered the question of liability of directors and a study has been prepared in order to provide the relevant information in a comprehensive manner for the 27 EU Member States and Croatia[3]. Such a study may help better understand how the question of liability of directors is dealt with in other European jurisdictions and may be a source of inspiration for Luxembourg.

What appears from the study is that there are gaps and deficiencies with regard to the substantive rules on directors' duties, especially in relation to enforcement of such rules. The authors of the study noticed that enforcement in most jurisdictions is confined to cases of fraudulent conduct and particularly serious breaches of directors' duties. It appears also from the study that in most Members States, judicial enforcement of directors' duties mainly or almost exclusively takes place after the company has filed for insolvency and that only a small fraction of claims against an insolvent company's directors are enforced in practice. This sounds quite relevant as far as Luxembourg is concerned.

In conclusion, what can be said is that even though enforcement of directors' duties and liabilities may not be so frequent, directors of several entities of a group of companies facing difficulties are in a very tricky situation. They must act prudently and diligently by taking into account the corporate interest of the group and the one of each individual entity of such group in which they have a mandate. In this context, directors should certainly seek appropriate legal and accountancy advice on a regular basis to ensure that all the entities are complying with their responsibilities. They should also be aware of the financial situation of the group and of the various companies and for such a purpose, they shall adopt a proactive approach and request to obtain on a regular basis (quarterly) an update of the operational entities.

In the case of cross collateralisation in a context of financing/refinancing, the directors shall pay particular attention to the corporate interest of the company to grant a cross stream interest/guarantee. When they are directors of several entities of the group, this assessment might be extremely difficult as it could be in the best interest of the entity receiving the financing but not in the one granting an upstream or cross stream guarantee. In this case, the directors need to consider with extreme attention whether they are caught in a conflict by being on a number of boards or by having dual roles that expose them to confidential information that they have a duty to share with the other co-directors. This happens especially with cascade structures where the director of the topco is also director of the holdco and both companies have different stakeholders. ■

Footnotes:

1 *Loi du 2 septembre 2011réglementant l'accès aux professions d'artisan, de commerçant, d'industriel ainsi qu'à certaines professions libérales.*

2 Proposal for a regulation of the European Parliament and of the Council amending Council Regulation (EC) n° 1346/2000 on insolvency proceedings.

3 Study on directors' duties and liability prepared for the European Commission DG Markt by Carsten Gerner-Beuerle, Philipp Paech, and Edmund Philipp Schuster (department of Law, London School of Economics, April 2013)

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