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*The European Initiative on Wrongful Trading*

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# **The European Initiative on Wrongful Trading**

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## Introduction

Company law has evolved to take into account the growing expansion of trade on an international basis, often termed globalisation, and the ease of incorporations across many jurisdictions for the conduct of business. This is of particular relevance when the formation of trading blocs, such as the European Union, is concerned. Given the ease of cross-border transactions, the phenomenon of the international manager capable of moving from jurisdiction to jurisdiction to direct the affairs of companies is well-known. It is also a feature of an age where cross-border mergers and take-overs lead to the creation of corporate groups across boundaries, involving entities incorporated according to the laws of different jurisdictions. While companies are solvent and prosper, there is little cause for concern apart from ensuring that business vehicles comply with regulations established in these states with respect to corporate operations. In situations of economic downturn and insolvency, other considerations come into play, not least the liability of management for mistakes that lead to irreparable damage occurring to the companies in their care. This phenomenon is well known in the laws of European countries and is increasingly to be found as a feature in many of the important countries in which business is done throughout the world. Part of the desire behind the establishment of these rules is to protect the interests of other participants in the process, notably the shareholders, creditors and employees. Although it is debatable just how far these measures can be effective, especially given the disincentive to risk-taking they may present, which is after all a powerful element in the business world, many jurisdictions enable courts to make findings of liability leading to the disqualification of directors from further office as a result of offences committed in the course of management. Other jurisdictions are also keen to ensure that liability leads to financial contributions, repairing some of the damage caused and contributing to the funds that will compensate some of the harm the other participants have suffered. In many of the jurisdictions concerned, developed principles of liability, both civil and criminal, are the subject of specific legislation. A formidable array of weapons is to be found in this legislation for use against the incompetent director. Indeed, the availability of a range of measures seems tailor-made to ensure that relative degrees of culpability are accordingly punished, ensuring protection of the public from the consequences of management mistakes. One of the areas in which management mistakes can occur is in the forecasting of insolvency and the responses managers make to the possibility that the businesses they direct may become insolvent. Although it may be argued the natural tendency of managers is to trade out of financial difficulties, the law is not entirely supportive of these types of decisions, particularly where continued trading only serves to deepen the indebtedness of the company and reduce the availability of assets for the satisfaction of claims. It is a somewhat

delicate matter on which different legal systems take different views about the appropriateness of sanctions for imprudent conduct of this type. Recent developments in Europe the subject of this article have put forward proposals for the creation of a rule at European Union level to deal with this phenomenon.

## A – The European Dimension

The European dimension to the company laws of the member states of the European Community (later Union) is evident. Since its foundation, the desire to harmonise certain aspects of the laws that promote the achievement of a common market has led to a substantial impact on domestic laws governing the operation of business vehicles. The primary context for a considerable number of measures in the company law field is provided by powers in Article 44(2)(g), EC Treaty that have been described as essentially ancillary to the rights of free movement for companies inherent in Articles 43 and 48, EC Treaty.<sup>1</sup> Progress on work reliant on this legal basis began early on in the life of the European Community and has concentrated on elements of the framework for company operations, including matters such as issues of share allotment and pre-emption rights, listing particulars, format of accounts and qualification of auditors as well as disclosure of information and there have been to date some nine Company Law Directives in these mainly technical areas. The use of directives in this area is explained by the requirements of Article 44(1), EC Treaty, a form that has some advantages in that they are a more flexible instrument and allow member states to choose effectively the method of transposition into domestic law that suits the domestic system.<sup>2</sup> Nevertheless, this does not rule out the type of detailed directives that may require incorporation 'verbatim' in national legislation, nor does it prevent some texts lacking 'transparency' because the transposition measures may not be immediately obvious or ascertainable to the user.<sup>3</sup>

Overall, the company law harmonisation initiative seemed to work well, although it may be argued that, after the failure of the proposals for worker participation and co-determination in the Draft Fifth Directive and those for corporate groups in the Draft Ninth Directive, subsequent proposals have tended to avoid the more problematic areas of company law, which include, in addition to the above, areas such as corporate personality, tortious liability and the question of directors' liability. Despite this focus on relatively benign instruments, some of the later proposals have failed to progress very far, notably the Draft Tenth Directive on cross-border mergers and the Draft Fourteenth Directive regulating cross-border

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<sup>1</sup>See Deakin, Regulatory Competition versus Harmonisation in European Company Law, ESRC Centre for Business Research, University of Cambridge Working Paper No. 163 (March 2000) at 5.

<sup>2</sup>It is by no means evident that transposition will not generate dissimilarities between member states, for an example of which, see Prentice, Section 9 of the European Communities Act (1973) 89 LQR 518.

<sup>3</sup>See Hopt, Company Law in the European Union: Harmonization or Subsidiarity? (1998) Seminar Paper No. 31, Centre for Study and Research in Comparative and Foreign Laws, University of Rome at 4-5.

transfers of registered offices. With the decline in the number of instruments being brought forward reliant on this legal basis, it has been assumed that the era of harmonisation proper is at an end and that little progress will be made on the remaining proposals outstanding. Some comfort is brought to this argument by the views of Charlotte Villiers, who charts the development of these directives, noting that they can be defined as falling into four discrete groups, ranging in impact from uniformity towards the creation of standards of reference and framework models, reflecting the move away from unification pure towards harmonisation in simple form.<sup>4</sup> Part of the explanation for the change in emphasis includes such reasons as the intrinsic difficulties of the harmonisation process and the need to complete the internal market in as effective a manner as possible.<sup>5</sup> It may also be possible that the use of this legal basis has occasioned some controversy following the introduction of qualified majority voting by the Treaty of Maastricht and the loss of veto rights, which may make it less attractive to member states as a conduit for harmonisation. Nevertheless, in the *Centros* case, the European Court of Justice noted that it was open to the Council on the basis of the powers in this article to achieve complete harmonisation of the issues that were in dispute, namely the vexed question of minimum capital requirements and uniform rules on shareholder and creditor protection.<sup>6</sup> Indeed, there have been calls in the wake of that case for a uniform European company law or, alternatively, for the preparation of model laws through a private initiative, such as a European Law Institute, that would promote harmonisation by member states, the advantage of this latter type of text being that it would provide legal integration without conceding sovereignty, a contentious issue within the European Union, in a way that might be necessary for the conclusion of a major code for company law in Europe.<sup>7</sup>

So far, it has been noteworthy that insolvency has failed to receive any mention in work-plans. The point has been made that company law harmonisation has 'always stopped short' of insolvency law.<sup>8</sup> In fact, the only substantial work in insolvency law has been the project that began with the working party looking into proposals for the enactment of a judgments convention under Article 293, EC Treaty that chose to hive off an insolvency project to a separate working party in 1963. While the main group successfully agreed an instrument that later became the Brussels Convention 1968,<sup>9</sup> the insolvency project ground to a halt repeatedly with the focus changing from complete harmonisation of both procedural and substantive rules to a partial harmonisation of select areas of domestic law accompanied by a scheme regulating jurisdiction and conflict of

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<sup>4</sup>See Villiers, *European Company Law: Towards Democracy?* (1998) Dartmouth at 19 passim.

<sup>5</sup>See Timmermans, *Harmonisation in the Future of Company Law in Europe*, paper given at a conference in Siena (30-31 March 2000) at paragraph 5.

<sup>6</sup>*Centros Ltd v Erhvervs- og Selskabsstyrelsen* (C-212/97) [1999] I ECR 1459; [1999] 2 CMLR 551 at paragraph 28.

<sup>7</sup>See Ebke, *Centros – Some Realities and Some Mysteries* (2000) 48 Am. J. Comp. L. 623 at 658-9.

<sup>8</sup>See Andenas, *Insolvency Proceedings in Europe* (1999) 20 Co Law 253 at 253.

<sup>9</sup>Since replaced by Council Regulation (EC) No. 44/2001 of 22 December 2000 (OJ 2001 L12/1).

laws issues to, finally, a simple jurisdiction scheme containing rules of recognition and conflict-avoidance. As a result, the Insolvency Regulation,<sup>10</sup> adopted in 2000 seems to be a measure quite distant from the ideal of harmonisation preached at the beginning of the overall initiative within the European Union. It might be argued that the same considerations which limited the use of Article 293, EC Treaty to harmonisation of conflicts rules have prevented over the years recourse to Article 44(2)(g), EC Treaty for any measure that would have the effect of introducing substantive harmonisation, a situation that would be as true for company law as it would for insolvency if the latter had been included in the work-plans. Nevertheless, it was reliably reported that, during one of the hiatuses in the insolvency project, caused by the United Kingdom failing to adhere, because of differences with the European Commission, in time to the European Insolvency Convention 1995, the Insolvency Regulation's predecessor, one of the options canvassed for implementation was to transfer the content of the text to a series of directives that would 'overcome a lack of consensus' but leave the progress of the initiative hostage to the speed at which member states implemented the proposals, indicating that, at least in some quarters, Article 44(2)(g), EC Treaty was seen as potentially having an insolvency vocation.<sup>11</sup> As will be outlined below, the revitalisation of the company law initiative that many felt was necessary has now come to have an insolvency component with the inclusion of proposals relating to wrongful trading.

By 2001, the company law harmonisation programme had clearly entered the doldrums with many feeling that the process had stagnated and was in a 'state of uncertainty' that did not bode well for its future.<sup>12</sup> In September 2001, the European Commission set up a Group of High Level Company Law Experts. Their remit was to initiate a discussion on the need for the modernisation of company law in Europe. Their brief was two-fold, first, to address concerns raised by the European Parliament in 2000 related to the negotiation of the Draft Thirteenth Company Law Directive dealing with take-over bids, secondly, to address the state of the company law harmonisation programme with view to providing the European Commission with recommendations for a modern regulatory company law framework in Europe. A number of issues were canvassed as a part of the consultation process that culminated in a report by the group in late 2002.<sup>13</sup> These issues included the creation and operation of companies and company groups, corporate governance, shareholders' rights, the use of technology for decision making, enhancing cross-border shareholder ownership, corporate restructuring and mobility and the need for possible new legal forms, particularly the European Private Company initiative sponsored by the Mouvement d'Entreprises de France and the Paris International Chamber of

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<sup>10</sup>Council Regulation (EC) No. 1346/2000 of 29 May 2000 (OJ 2000 L160/1).

<sup>11</sup>See Torremans, Cross-Border Insolvencies in the EU [1999] 4 Insolv L 183 at 184.

<sup>12</sup>See Davies, Gower and Davies' Principles of Modern Company Law (2003) Sweet and Maxwell at 113.

<sup>13</sup>Documents that originate as part of the consultation may be viewed through the EU website at: <europa.eu.int/comm/internal\_market/en/company/company/modern/index.htm>.

Commerce. Furthermore, in light of an ongoing scheme aiming at simplification of legislation within the Single Market (also referred to as the SLIM initiative), the group was to look at the possible further simplification of company law rules, including those arising from the recommendations made relating to simplifying the First and Second Company Law Directives.<sup>14</sup> The outline in the consultative document in Chapter 3 under the rubric of Corporate Governance contains a Title IV dealing with the strengthening of the duties of the board and increasing the accountability of directors in situation where the company they govern becomes insolvent. The document states that the issues of corporate governance and shareholders' rights are about controlling the directors as the agents of the shareholders. Similarly, they are about holding the directors accountable if control comes to late to prevent the company from entering insolvency. Part of the document is also about introducing measures designed to enhance the ability of shareholders to hold directors accountable, including by introducing a special investigation procedure as a means for revealing information about the internal affairs of the company and the role directors have played in conducting these. Although the overall aim is to allow shareholders too intervene early, for example to replace directors, it is recognised that intervention may come too late to prevent the company from suffering harm at the hands of the directors. It is also noted in the document that all of the member states have rules on directors' liability that form part and parcel of core company law but that are couched in very different terms. The document makes it clear, however, that it was not intended that there be a comprehensive codification or harmonisation of the rules on directors' liability, which would be likely to be futile, particularly as the rules were undergoing extensive modification in many member states.<sup>15</sup>

Nevertheless, the document makes reference to the fact that, in a number of Member States, there are specific rules for holding directors accountable if the company becomes insolvent. There are a number of different formulations of this rule, ranging from the wrongful trading rules in the United Kingdom, to the 'action en comblement du passif' known to French and Belgian law and the liability incurred by directors in Germany and France for failing to declare the insolvency of the company within a set period. Admittedly, the document states that in many member states, rules relating to what might be described as wrongful trading fall to be dealt with by the ordinary law of directors' liability. The document also points out that the concept of wrongful trading is applicable to both single companies operating independently as well as members of corporate groups. It is particularly relevant where directors of the subsidiary company as well as those of the parent or holding company may become subject to the principle, especially if the latter are qualified as de facto or shadow directors of the former entity. The rule is considered useful in that it does not impede the making of business decisions and does not circumscribe the ability of the directors to act in the best

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<sup>14</sup>Council Directive No. 68/151/EEC (OJ 1968 L65/8) and Council Directive No. 77/91/EEC (OJ 1977 L26/1) respectively.

<sup>15</sup>A Modern Regulatory Framework for Company Law in Europe: A Consultative Document of the High Level Group of Company Law Experts at paragraph 12.

interests of the company provided the company does not become insolvent. The risk to directors, according to the document, lies at a 'crisis point' where, if the company cannot continue to pay its debts, a choice must be made to either rescue the company or to submit it to formal insolvency proceedings and the risk of liquidation. The choice does not come without a risk as the wrong choice may well involve the directors of the company and, in certain circumstances, those of related companies, becoming liable to the creditors for claims against the debtor company that remain unpaid.<sup>16</sup> The document considers that the introduction of a framework rule at European level could be a considerable improvement for the operations of companies. The reason given is that protection of creditors could be enhanced without compromising the ability of directors to make choices about the functioning of the enterprises they manage, including the choice, when insolvency looms large, about the fate of the company itself. The existence of a Europe-wide rule would do much to enhance the confidence of creditors and their willingness to deal with companies as trading partners. Part of the rationale for a supranational rule is said to be the inherent risk in doing business across borders where information may be more difficult to obtain, thus prompting the desire to introduce an equivalent level of protection for creditors of companies across the European Union. It will be recalled that the Court in *Centros* mentioned in its judgment the possibility of just such a step so as to promote creditor protection. All this would be achieved without necessarily harmonising the body of rules relating to directors' liability in the member states.<sup>17</sup> To that end, the consultation contained a specific question worded as follows:

'Question 10: Should the European Union introduce a framework rule which would hold company directors accountable for letting the company continue to do business when it can no longer pay its debts?'

What is interesting is that the responses came out in favour by a majority of some 56% for a rule that would hold company directors accountable in instances when companies continue to trade where it is foreseeable that the business will not be able to meet its debts.<sup>18</sup> Admittedly, the limited number of responses, some 81 in total, would not at first indicate that there is an overwhelming case to be made for any rule in this area were it not for the fact that the responding parties included, inter alia, Governments of the member states, business and professional bodies, corporate entities, professionals in the industry and academics; sufficient perhaps to give a feel of the weight of opinion in Europe for such a measure.<sup>19</sup> Despite this majority, however, many respondents emitted cautious views by supporting a restricted scope for the rule or that it should be very general in nature or, indeed, that the rule should be dealt with in the context of an insolvency initiative. Furthermore, a significant minority of about 40%

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<sup>16</sup>Ibid., at paragraph 13.

<sup>17</sup>Ibid., at paragraph 14.

<sup>18</sup>Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe ('Final Report') at page 145 (in Annexe 3).

<sup>19</sup>Ibid., at 132-135 (in Annexe 2), where a breakdown of responses is summarised.

existed that would not support a rule of this type, citing the existence of practical problems involved in the harmonisation process and the fact that many national systems already have efficient rules dealing with this area, including Germany, Sweden and Ireland. Many of the objections stem from the view that a company law initiative should not deal with what is clearly an insolvency law matter and, furthermore, that the subject is not an ideal one for harmonisation.

The Final Report, issued on 4 November 2002, contained recommendations reached as a result of the consultation process and identified what the Group of Experts considered to be the priorities for a European Union company law action plan. The ambitious nature of the plan necessitated the identification of priorities that could be carried out on a short-, medium- and long-term basis. The firm conclusion as to wrongful trading was that a rule should be introduced to cover situations where directors foresee or ought to foresee that the company cannot continue to pay its debts and that, consequently, a decision must be made as to the company's future and whether it is to be rescued or liquidated. The view was that personal liability should be incurred for the consequences of a company's failure in the absence of the right choice being made. The Final Report acknowledges that some respondents to the consultation process were of the view that a wrongful trading rule was firmly within the province of insolvency law. Despite this, the Group of Experts disagreed, stating that their view was that the issue of whether directors are to be made responsible (liable) is at its most important prior to insolvency. They consider it to be a key element of an overall corporate governance system appropriate for companies. Although national rules exist that stipulate for liability where directors do not react appropriately when a forecast of insolvency can reasonably be made, their detail varies considerably. What is common to these rules is that they do not interfere with ongoing management and the making of business decisions, but helpfully deal with the situation of single and group companies. Because the majority of responses to the consultation supported the introduction of a rule at European Union level on wrongful trading, the group felt that such a rule was justified as it would enhance the confidence of creditors and introduce an equivalent level of protection for trading partners across Europe.<sup>20</sup> Recommendation III.13 was therefore for the introduction of a rule of accountability applying to actual and shadow directors alike for letting the company continue to do business when the company's inability to pay its debts ought to be foreseen.<sup>21</sup> The exposition of the reasoning for this recommendation comes later in the Final Report in Chapter III dealing with Corporate Governance issues generally and with the wrongful trading rule in paragraph 4.4, which repeats much of the reasoning set out in the consultation with appropriate commentary in light of the responses and the analysis carried out on the group's behalf by a team from the law department of the Erasmus University in Rotterdam.<sup>22</sup> The Final Report also makes the recommendation that

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<sup>20</sup>Ibid., at 9.

<sup>21</sup>Ibid., at 12.

<sup>22</sup>Ibid., at 68-69.



action on a wrongful trading rule should be carried out as a medium-term priority.<sup>23</sup>

## B – The Domestic Dimension

In order to assess whether the wrongful trading initiative might be successful, it will be opportune here to examine the rules that exist at domestic level in some of the member states so as to illustrate the differences that will need to be taken account of during the drafting of the text that will contain the wrongful trading rules.

### (i) The United Kingdom<sup>24</sup>

The law in England and Wales is firmly based on specific statutory provisions contained in the Insolvency Act 1986 and that impose liabilities upon directors in connection with the liquidation of companies. These include compelling a director to contribute to the company's assets where the company is in liquidation and the director has misapplied company property or is breach of duty.<sup>25</sup> Furthermore, where a company's business is being carried on with the intention to defraud creditors or for any fraudulent purpose, the courts may order any person, including a director, who is a knowing party to the fraud, to contribute towards the company's assets on a winding-up.<sup>26</sup> The provisions characterised as rules on wrongful trading appear in the same part of the Insolvency Act and provide that courts may order directors of the company to make contributions to the assets.<sup>27</sup> These rules are without prejudice to the application of the fraudulent trading rules in the preceding section, rendering them both of potential application dependent on the facts.<sup>28</sup> The essence of these provisions is that they apply, where a company is in insolvent liquidation, to a director or former director who, before the winding up, knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation and who did not take every step with a view to minimising the potential loss to the company's creditors which he ought to have taken. This provision also applies to shadow directors, particularly those in two categories potentially caught by this rule, parent companies and banks. The courts have held that an essential element of the shadow director's position is that the company must have ceded to the shadow director some or all of its management authority. In cases where banks merely act to preserve their own interests by dictating a course of action to their debtors, courts have been reluctant to impose liability, holding that companies retain the choice as to whether or not to accept what the banks wish

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<sup>23</sup>Ibid., at 126.

<sup>24</sup>The internal jurisdiction chosen for this section is that of England and Wales.

<sup>25</sup>s212, Insolvency Act 1986.

<sup>26</sup>Ibid., s213. This is commonly referred to as the 'fraudulent trading' rule.

<sup>27</sup>Ibid., s214.

<sup>28</sup>Nevertheless, it should be noted that fraudulent trading has a penal element, whereas the wrongful trading rules are civil in nature and tend towards compensation as the guiding principle.

to impose.<sup>29</sup> In relation to parent or holding companies, the courts are more willing to hold that the subsidiary's autonomy is impaired provided that the facts tend to support this contention. Questions of commonality of management and decision-making, the interests of the companies at stake and whether conflicts are resolved in the favour of the parent or subsidiary are all factors to be taken into account. Nevertheless, an objective assessment, whether of a de facto or de jure director's position, will need to ask two things: whether the director in fact realised or should have realised that the company could not avoid insolvent liquidation under any reasonable assessment of its prospects and whether the director had in fact taken all necessary steps to minimise the loss to creditors.<sup>30</sup> Although these assessments are ones to be based on the facts of the case, one question that might be asked is whether in this event there is a positive duty on directors to stop the company from trading and to open liquidation proceedings.

It should be noted that the above provisions are boosted by a formidable array of weapons to be used against delinquent directors in the Company Directors Disqualification Act 1986, which provides that unfit directors of insolvent companies may be disqualified from being concerned with the management of other companies. Furthermore, there are a range of other offences in insolvency law that result in penalties of imprisonment or fines for directors of insolvent companies committing these offences. With this in mind, practical advice would be that, faced with all these potential liabilities, directors of companies in England and Wales would be well advised to perform a number of key activities. These would include the keeping of management accounts, the preparation of regular budgets and forecasts, the monitoring of the company's financial position on a regular basis, as well as seeking and following, where appropriate, advice given by accountants or insolvency practitioners where the company is in financial difficulties.<sup>31</sup> It is stated that the courts do not normally, when faced with a company in financial difficulties, use hindsight to judge the actions of directors, but will form a view of their actions on the basis of the information actually known to them or which a reasonable diligent director would have ascertained at the relevant time.<sup>32</sup> In the case of a director who takes no action, when objectively it may be argued he should do so, or who relies too much on the action or advice of fellow directors, he may be held liable to contribute to the company's assets. Nevertheless, difficulties attend the position of a director who believes that the company is in danger of insolvent liquidation but who cannot convince the rest of the board of the perils facing the company. Where the board in fact fails to agree to steps aimed at minimising the loss to the company's creditors, the director might wish to resign in order to avoid a potential liability. However, the section does not provide that a director who has resigned is absolved from liability, as it also covers former directors, who remain liable for their acts or omissions once

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<sup>29</sup>Re: Hydrodan (Corby) Limited [1994] 2 BCLC 180.

<sup>30</sup>See Davies, *op. cit.* at 197.

<sup>31</sup>See Pritchard, Chapter 3 (England and Wales) in Omar (ed.), *Directors' Duties and Liabilities* (2000) Ashgate at 32.

<sup>32</sup>*Idem*, citing Re: Sherborne Associates Ltd. [1995] BCC 40.

they become aware or ought to have become aware of the likelihood of insolvent liquidation. Directors at odds with the rest of the management team should in such circumstances continue to seek to persuade their fellow directors to take appropriate action to minimise the potential loss to the company's creditors, and ensure that their advice is fully recorded.<sup>33</sup> This is a practical view that nevertheless illustrates the difficulties attendant on directors second-guessing the economic climate in order to predict their company's chances of success.

The importance of these provisions is signalled by the fact that the Company Law Review, initiated in 1998, included it as part of the raft of directors' duties to be codified as a statement of general principles. Although it was omitted in a later version, the reason seems to have been not that it was considered unimportant, but that it was felt that the principle should be retained within insolvency legislation, where the appropriate enforcement mechanisms exist to give the section effect.<sup>34</sup> Nevertheless, there are doubts about the utility of the provisions, given that there seem to be very few instances on the use of the section to pursue claims and even fewer reported decisions on the scope of the provisions. One reason may be that the initiative, given to liquidators by the section, may so rarely be seized because liquidators are unwilling to expend assets in the pursuit of litigation unless there is an overwhelming prospect of success. Given that the costs of litigation may not necessarily be met as of right from the insolvency estate, even though courts have the power to accord priority to the litigation costs as a claim against the estate, the uncertainty acts to dissuade liquidators from embarking on litigation under this section.<sup>35</sup> Nevertheless, the *raison d'être* for this section is stated as being that it acts as a counter-incentive for directors to maximise their own position as shareholders by seeking to trade out of insolvency, a course of action that is unlikely to have a great chance of success, because they enjoy the protection of limited liability should they fail. The imposition of liability would tend to make directors consider the interests of the creditors more, given that the creditors' interests are most at stake in situations where shareholders' equity has already been exhausted and the company is in effect trading with the creditors' money, supplies and credit.<sup>36</sup> This is perhaps one of the more cogent justifications for retaining a rule that in its original form was intended to allay concerns about the ineffectiveness of the fraudulent trading provisions, owing to the criminal burden of proof being necessary, by introducing a civil version.<sup>37</sup>

## France

In France, a developed liability regime is the subject of the law of insolvency, recently codified in the Commercial Code 2000. There are three chapters that set

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<sup>33</sup> *Idem.*

<sup>34</sup> See Davies, *op. cit.* at 199.

<sup>35</sup> *Ibid.*, at 200.

<sup>36</sup> *Ibid.*, at 198-199.

<sup>37</sup> See Keay and Walton, *Insolvency Law: Corporate and Personal* (2003) Longman at 523.

out this regime, two referring to civil liability for acts related to the management of companies, which include a Chapter IV headed: 'Particular Provisions applicable to Private-Law Bodies and their Directors'<sup>38</sup> and a Chapter V headed: 'Personal Bankruptcy and Other Measures of Interdiction'.<sup>39</sup> The remaining Chapter VI deals with criminal offences and penalties and is headed 'Criminal Bankruptcy and other Offences'.<sup>40</sup> The regime which applies in insolvency is very much distinct from the penalties and punishments which apply in general company law, particularly to the offences and misdemeanours codified in the former Companies Law of 1966.<sup>41</sup> When a company has reached the stage where it becomes unable to pay its debts, it has only 15 days in which to make a formal declaration of insolvency to the court.<sup>42</sup> The directors may be held personally liable for all or part of the debt if the company continues to trade without a declaration being made. A court may decide when a company becomes technically insolvent, at which point the 15-day deadline begins to run, and is at liberty to fix the date when the company entered insolvency at up to eighteen months before the date of the judgment opening insolvency proceedings.<sup>43</sup> A court is not bound by this date when it makes a ruling finding liability on the part of a company director and need not consider whether a director had any valid reasons for delaying a declaration once it has established a date when the company entered insolvency.<sup>44</sup>

The definition of director covers both appointed directors and shadow directors.<sup>45</sup> A director who leaves the company before the date of the insolvency judgment may not necessarily escape liability as the Supreme Court has ruled that, if cash-flow problems, leading to the insolvency of the company, existed while the former director was still in office and were known to him, he may yet be held liable for mismanagement.<sup>46</sup> Another decision has held that an appointed director can not exculpate himself by pursuing the shadow director for a contribution to the debts of the company.<sup>47</sup> Similarly, an appointed director may not evade responsibility by presenting as his defence the fact that he had abandoned his duties to a shadow director.<sup>48</sup> Furthermore, an action against a director under these provisions is not considered penal in nature and may even survive the director's demise to be brought against his heirs.<sup>49</sup> Other parties may also be treated as directors,

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<sup>38</sup>Dispositions particulières aux personnes morales et à leurs dirigeants' (Articles L624-1 to L624-7). This chapter is the subject of the present section.

<sup>39</sup>De la faillite personnelle et des autres mesures d'interdiction' (Articles L625-1 to L625-10).

<sup>40</sup>De la banqueroute et des autres infractions' (Articles L626-1 to L626-19).

<sup>41</sup>Law no. 66-537 of 24 July 1966, now codified in Book II, Commercial Code 2000.

<sup>42</sup>Déclaration de cessation des paiements'. 'Cessation de paiements' is defined as 'the inability to settle those debts which are due with the available assets.'

<sup>43</sup>Article L621-7, Commercial Code.

<sup>44</sup>Cassation commerciale, 30 November 1993, RJDA 94-4, no. 460; Cassation commerciale, 10 October 1995, RJDA 96-1, no. 136.

<sup>45</sup>'Dirigeant de droit' and 'dirigeant de fait' respectively.

<sup>46</sup>Cassation commerciale, 13 December 1982, Bull Civ. IV No. 408. Cassation commerciale, 27 avril 1993, Rev sociétés 1993.871.

<sup>47</sup>Cassation commerciale, 6 June 1995, Le quotidien juridique 95-62 at 2.

<sup>48</sup>Cassation commerciale, 9 May 1995, Le quotidien juridique 95-53 at 2.

<sup>49</sup>Cassation commerciale, 24 avril 1981, Bull. Civ. IV no. 180.

including creditors and banks, due to the close relationship that may develop through the supply of goods and credit. It is not unknown for a banker to act as a director, appointed under the company's articles of association, with the consequence that he may be liable for acts committed during his period of office.<sup>50</sup> Furthermore, a person enjoys the status of a shadow director where he exercises the powers of a director to the extent that he is able to make financial and commercial decisions which bind the company. This may occur where he exercises the powers of a director regularly or in his absence or where he represents to third parties that he is a company director, or where he exercises influence on the directors so that they act in accordance with his instructions. A company which satisfies the above conditions may be considered to have the status of a shadow director, in which case the representative of that company on the board of the insolvent company may be held jointly and severally liable with the company itself for the debts of the insolvent company.<sup>51</sup> A holding or mother company may be considered to exercise the role of a shadow director in one of its subsidiaries if it plays an important role in management decisions.<sup>52</sup> A mother company may also be held liable where both companies give the appearance of being interdependent and under the same management as identity of management and pursuit of common aims or commercial activity are key factors in assessing the reality of separate company identity. In fact, companies which share a common manager may find that insolvency proceedings involving one company may be extended to all companies thus associated.<sup>53</sup> If a company and a creditor share one or more directors, there may also be a question of whether the personal link is strong enough to have influenced the company's decisions.

Company directors will often be the subject of a claim for a contribution<sup>54</sup> where the company is insolvent and its assets are insufficient to repay the debts of the company. An essential prerequisite is that the company is first placed under formal insolvency proceedings.<sup>55</sup> The claim may be brought by the insolvency practitioners or the public prosecutor and proceedings may also be opened by the court itself acting of its own motion.<sup>56</sup> The sole criterion for the application of the law is that the insolvency proceedings in respect of the company have revealed a deficiency in the assets to which the director may be found to have contributed.<sup>57</sup> In addition, the directors of an insolvent company which is in insolvency proceedings will also be subject to personal bankruptcy where they have failed to discharge their liability for contributions to the repayment of the company's debts.<sup>58</sup> The same rule applies in situations where they have used the company's assets as their own, used the company to carry out their personal business, used the

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<sup>50</sup>Cassation commerciale, 24 January 1983, RJ Com. 1984.215.

<sup>51</sup>TC Paris, 5 January 1994, RJDA 94-4, no.456.

<sup>52</sup>CA Aix-en-Provence, 26 May 1981, D.1983.IR.60.

<sup>53</sup>Cassation commerciale, 8 February 1994, Les Petites Affiches, 24 May 1995 no. 62 at 33.

<sup>54</sup>'Action en complément du passif.'

<sup>55</sup>Article L624-2, Commercial Code.

<sup>56</sup>Ibid., Article L624-6.

<sup>57</sup>Ibid., Article L624-3.

<sup>58</sup>Ibid., Article L624-4.

company's assets or credit for personal gain contrary to the company's interest or for the benefit of another company in which they have a direct or indirect interest, conducted the business of the company in an abusive manner for personal gain, resulting in the insolvency of the company, destroyed, falsified or failed to keep proper accounts or misappropriated or concealed company assets or fraudulently increased the company's debts.<sup>59</sup>

It must be proven generally that the director in question was guilty of an act of mismanagement which caused the loss of assets that contributed to the company being unable to meet its debts. The liability of company directors must be shown by a causal link between the act of mismanagement and the debt which arises. It is not necessary to prove a direct link between a specific act and the damage which results.<sup>60</sup> Similarly, it need not be the main or only cause. The concept of mismanagement is left undefined in the law and courts have therefore had to decide on a definition of mismanagement on a case to case basis. This type of claim normally requires proof that a director has been guilty of a fault in management judged by the standards of the normally well-advised director. Case law has provided a number of examples including imprudence, lack of attention and failure to act, while the most common findings of mismanagement have occurred where company directors have allowed the company to trade while manifestly insolvent and have embarked on projects beyond the company's financial capacity and which were not in its best interests.<sup>61</sup> Furthermore, liability also attaches where directors have engaged the company in transactions, neither at arm's length nor of a commercial nature and have improperly extended credit beyond the company's means, relying simply on the banks to meet the company's cash flow needs. Mere incompetence can also be deemed to be a fault. Alternatively, it is not necessary to prove gross negligence. Where a director of a public company acts passively by not participating in management, this is often sufficient to hold the director liable for a contribution to company debt.<sup>62</sup> A court may fix the proportion in which directors may be liable to contribute and is not required to consider whether or not the director in question was remunerated for his services nor whether any internal arrangements existed to indemnify directors against liability. The maximum liability that may be imposed by a court is the difference between available assets and the sum necessary to meet its debts, regardless of whether or not the director in question was entirely responsible for the debt occurring.<sup>63</sup>

### (iii) Germany<sup>64</sup>

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<sup>59</sup>Ibid., Article L624-5.

<sup>60</sup>Article L624-3, Commercial Code.

<sup>61</sup>CA Aix-en-Provence, 9 December 1993, D.95.33.475.

<sup>62</sup>Cassation commerciale, 31 janvier 1995, JCP G 1995, 3865.

<sup>63</sup>Cassation commerciale, 30 November 1993, Bull. Civ. IV no. 440.

<sup>64</sup>This section is based on material included in Bröhmer, Chapter 5 (Germany) in Omar (ed.), op. cit. at 58-59 and 62.

In Germany, liabilities in the case of losses or insolvency fall to be considered depending on the incorporation form of the company in question, whether it is a joint stock company or limited liability company.<sup>65</sup> In cases of financial difficulties involving the former, certain duties are laid on directors, which serve two different objectives.<sup>66</sup> The first objective is an internal one in order to inform the shareholders of the difficulties being experienced by the company for them to act through the general meeting of shareholders. The second looks to a wider perspective and the right of the public in general and the creditors in particular to be informed of matters in order to safeguard their position in a proper winding up of the company. The law requires the Board of Directors to immediately convene a general meeting of shareholders where either the annual or interim reports show or other factors indicate that a loss of at least one half of the original capital has occurred or is imminent.<sup>67</sup> The definition of immediacy is contained in the Civil Code and is interpreted as meaning without culpable delay,<sup>68</sup> although any delay in convening the requisite meeting will not be regarded as culpable, for example where concrete restructuring negotiations are underway.<sup>69</sup> The law then requires the Board of Directors to file for insolvency or enter into composition arrangements either immediately or, in any event, no later than three weeks after the moment the company becomes insolvent, that is where its debts exceed the aggregate value of the company's assets.<sup>70</sup> In both instances, directors must cease making any payment to third parties unless these payments are compatible with the care to be expected from a proper and conscientious director fulfilling his duties.<sup>71</sup> Insolvency is defined as the inability to pay debts as they fall due.<sup>72</sup> Breach of the duty to convene a meeting of shareholders will entitle the company to bring an action for damages against the Board of Directors. Although creditors are excluded from a claim under this heading, there is a question as to whether shareholders may enjoy a similar claim for damages. Breach of the duty to file for insolvency proceedings or to enter into composition arrangements may also lead to claims by the company as well as by the creditors. In this instance, however, shareholders are excluded from bringing a claim. In the case of creditors, they are entitled to claim damages for the difference between their position after the breach and their position had the breach not taken place.<sup>73</sup> Breach of the moratorium on payments in the law will also entitle the company to bring a claim insofar as the assets have been diminished by any payments made.<sup>74</sup> The duties of a director of a GmbH in the case of loss or insolvency are very similar to those duties described above in the case of directors of an AG. The loss of fifty percent or more of the original capital will require the immediate

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<sup>65</sup>Aktiengesellschaft ('AG') and Gesellschaft mit beschränkter Haftung ('GmbH') respectively.

<sup>66</sup>Article 92, Aktiengesetz (Law dealing with AGs).

<sup>67</sup>Ibid., Article 92 sec. 1.

<sup>68</sup>Article 121, Civil Code.

<sup>69</sup>See Hüffer, Aktiengesetz (1997) for commentary under Article 92 at paragraph 6.

<sup>70</sup>Article 92 sec. 2, Aktiengesetz.

<sup>71</sup>Ibid., Article 92 sec. 3.

<sup>72</sup>Article 102 sec. 2, Konkursordnung (Insolvency Law).

<sup>73</sup>BGHZ 126, p. 181 at 190 and following.

<sup>74</sup>See Hüffer, op. cit. Article 92 at paragraph 20.

convening of a general meeting of shareholders.<sup>75</sup> In the case of insolvency, directors must petition for bankruptcy proceedings immediately. In any event, they must act no later than 21 days after the company has entered insolvency, defined as the situation where the company's debts exceed the aggregate value of the company's assets.<sup>76</sup> Directors will also be liable to the company for any payments made after this time unless these payments were of the type to be expected of a 'proper businessman conducting business.'<sup>77</sup>

#### (iv) The Netherlands<sup>78</sup>

In the event of insolvency, directors can be held personally liable for the debts of insolvent companies where two conditions are fulfilled. First, where there is proof that, during a period of three years before the company became insolvent, the Board of Directors clearly performed its management duties in an improper manner. Second, where, on a balance of probabilities, this mismanagement was an important cause of the company's insolvency. It being the case, the directors are jointly and severally liable. Nevertheless, the law does provide that the courts may exercise a discretion to reduce the amount by which a director is liable in certain circumstances, for example if the nature and seriousness of the mismanagement do not warrant the extension of full liability. Furthermore, directors are usually given the benefit of the doubt on the assumption that business risks are an unavoidable and incidental part of management. The case law does give illustrations of situations where a presumption of mismanagement can arise. These include where directors have failed to undertake sufficient research into the financial soundness of business partners or other important factors before entering into contracts, where directors fail to provide sufficient information to enable the Supervisory Board to exercise supervision over management, where directors neglect the proper financial administration of the company, where they also neglect to take preventative measures against clearly foreseeable risks and, lastly, where bad personnel management by the directors leads to unrest and strikes. Furthermore, there is also a presumption that mismanagement is an important cause of insolvency where annual accounts have not been filed or where statutory provisions with respect to bookkeeping have been breached. These mismanagement provisions also apply to members of the Supervisory Board with regard to the performance of their duties and to those considered by the law to act as 'co-determinators' helping to formulate company policy. Furthermore, the insolvency of the company may also lead to criminal liability being attached to directors.

#### (v) Spain<sup>79</sup>

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<sup>75</sup>Article 49 sec. 2, GmbH-Gesetz (Law dealing with GmbHs).

<sup>76</sup>Ibid., Article 64 sec. 1.

<sup>77</sup>Ibid., Article 64 sec. 2.

<sup>78</sup>This section is based on material included in Carrière, Chapter 7 (The Netherlands) in Omar (ed.), op. cit. at 85-86.

<sup>79</sup>This section is based on material included in Hallett, Chapter 9 (Spain) in Omar (ed.), op. cit. at 116-117.



In situations where a company in Spain is to be wound up, directors are required to convene a general meeting of shareholders in order to pass a winding-up resolution within two months of any one of the following grounds for winding-up coming into existence. This period begins as from the day directors acknowledge the existence of one of the grounds for winding-up, although commentators are not united on this view. The grounds for winding up include the completion of the business constituting the purpose for which the company being incorporated, the impossibility for the company to carry out its objects or the administrative paralysis of company bodies rendering their functioning impossible, the occurrence of loss reducing the net assets to an amount less than half of the share capital, except where the share capital is subsequently increased or reduced accordingly, the reduction of the share capital to below the legal minimum and, lastly, any other grounds provided for in company articles. Directors are required to apply for winding-up of the company by court where the general meeting of shareholders opposes or fails to pass a resolution for the winding up of the company. The law on stock companies imposes a strict duty on the part of directors to act in cases where the company suffers financial difficulties by providing for joint and several liability for company debts in two particular cases. First, where directors fail in their duty to convene a general meeting within the period of two months described above and where the directors fail to apply to court for insolvency proceedings to be opened in respect of the company within a further period of two months from the date set for that general meeting, where in fact it did not take place or from the actual date of the general meeting, where the resolution passed was against the winding up of the company. In cases where compliance with these requirements occurs after the expiry of any deadline the law provides, it is beyond doubt that directors will be liable for the company's debts, although the amount of damages arising as a result of any failure may be reduced or mitigated where the failure does not affect the efficient winding-up of the company. This provision of the law on stock companies also entails severe consequences for directors as creditors of the company may demand payment of any and all of the debts entered into by the company from the debtor company but also, on the basis of joint and several liability, from its directors.

## Summary

It is instructive to note that there are major differences in the types of liability regimes within the European Union. This is true even of jurisdictions with a shared legal history and similar legal cultures. What is obvious is that there is an array of different treatments of the question of liability for situations that can be qualified as amounting to wrongful trading. In some instances, this behaviour is the subject of sanction in very specific sections of a primary statute dealing with insolvency or even with corporate law. In others, there is an overall liability regime, often inherited from general civil law, of which insolvency liability forms a part. In still others, the behaviour sanctioned forms only a part of a larger overall scheme to

deal with the concept of management mistakes and liability for causing the company to enter insolvency, of which wrongful trading is only an example of negligent conduct. There are also differences in how claims may be brought, particularly the departure point for proceedings and the duration of the relation-back period. In different jurisdictions, different parties are invested with the power to act and there is a particular difficulty in the definition of parties against whom claims may be brought, particularly as there is no single concept of a director. It seems difficult in this situation to imagine that a single rule could be propounded that could effectively harmonise all the scenarios above, especially as there may be issues difficult to compromise on, for example, the latitude of discretion to be allowed to directors faced with the prospects of insolvency and what credit may be given to the business judgments they may make, where faced with the temptation of trading out of difficulties. There may also be doubts as to whether the regimes that currently exist at domestic level in the member states of the European Union in fact exhibit sufficient similarities to make the introduction of a wrongful trading rule at European level possible, as was argued by some of the respondents to the consultation when defending the efficiency of domestic laws dealing with wrongful trading. As a result, it might be argued that finding a consensus on the content of such a rule will prove to be difficult, although the Group of Experts seem reasonably confident that a text can emerge. Nevertheless, one advantage of conducting just such a process may well be that the existence of a wrongful trading rule, if ultimately seen as successful in practice, will mark a shift towards trying to harmonise directors' liability at the European Union level. This may pave the way towards acceptance of a general principle of liability for directors that would sit well with other measures in the field of Corporate Governance, whose adoption the Group of Experts have recommended in their Final Report. This may be welcomed if it renders the functions and duties of directors easier to fathom in an age when cross-border trade is no longer the exception and directors consequently require better information and security as to their duties in other jurisdictions. Furthermore, this work may well prompt, given its closeness and relation to other insolvency issues, similar initiatives on those issues where sufficient consensus can be built for harmonisation projects to be developed.

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