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Saving the GOING CONCERN:
Must the Crew Abandon the Ship?

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Corporate and Professional Responsibilities in Bankruptcy

Portugal

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I – INTRODUCTION

A number of changes implemented by Portuguese law regarding Directors and Officers' duties and liability implemented by Portuguese law in the recent past lead to a more strict position of Directors and Officers towards the stakeholders of Portuguese companies.

The more stringent obligations and liability regime is expected to have a positive impact towards the conduct of Directors relating to the management of the business of a company, including in respect of rescue/reorganization of going concern entities.

II – INSOLVENCY LAW

The new Portuguese Insolvency law in force since the end of 2004 is in line with the EU Insolvency Regulation, integrating the concept of the centre of the debtor's main interest and providing for rules for jurisdiction of Portuguese courts for the opening of insolvency proceedings, the automatic recognition of these proceedings pending in other member state and the powers of the liquidator.

The new law in order with the EU Insolvency Regulation sets out as main goal to assist Portuguese courts, business undertakings and legal professionals in carrying through or settlement of cross border business and transactions in cases of an insolvent debtor that does operate in Portugal and elsewhere in the EU.

In contrast with EU recommendations, the new Portuguese insolvency law does however put emphasis on the repayment to the creditors shifting away from the reorganisation of the company or business in debt. The reason for this is because the old law which was principally concerned with the rescue of debtor had little impact in practice in terms of recovery of businesses but allowed that most creditors never were repaid.

The old law was a complex statute containing a number of formalities which delivered to the court the main responsibility on the proceedings. Insolvency cases lasted for years with all the negative consequences thereof.

In practice, the main goal to which the proceedings were aimed at – the to rescue of the insolvent company through the application of one of the measures legally foreseen and which ranged from a "controlled management" to a number of hybrid solutions which implied the joint court and creditors' control over the company's management - implied serious delays in the progress of the proceedings, which, in the end, almost invariably ended with the sale of assets, at a stage where the assets have devaluated or disappeared.

Under the new Insolvency Law, the proceedings are a hold as a mechanism for the protection of the company and respective assets, aimed at the subsequent sale of the company's assets, satisfaction of the creditors and winding up of the company.

Accordingly, the first article of the new Insolvency Law reads that insolvency proceedings are mainly aimed to liquidate the company's assets and to pay the creditors or to satisfy by any means the creditors' rights. Satisfaction of the creditor's rights through the implementation of an insolvency plan is also foreseen but as a secondary resource.

The structure of the proceedings foreseen in the new law is clearly oriented to the prompt and efficient satisfaction of creditors rights, handing over to the creditors the lead of the proceedings with the role of the court resuming to the monitoring of the legality of the actions taken.

The new insolvency law further provides for a more stringent liability regime for Directors. Under a so called "incident of qualification of insolvency" the conduct of Directors will be evaluated in order to ascertain whether the manner in which the business of the company was managed led to the insolvency.

The court may decide to bring forward an investigation to establish whether the situation that led to the insolvency was caused or aggravated by the "mismanagement" or "faulty management" undertaken by the insolvent company's directors, within the three years prior to the insolvency order.

Should the insolvency be deemed faulty (fraudulent) and the Directors held culpable, they may be prevented from exercising any business activity for a period which ranges from 2 to 10 years, loose any credits they have against the Company, etc.

Fraud is presumed when Directors fail to file for insolvency proceedings, in a maximum stated period of 60 days from the moment they became aware that the company's debts surpass the assets, or that the company is unable to satisfy its obligations.

Aggravation of the applicable penalties to fraudulent insolvency, frustration of credits and negligent insolvency, as well as to favouring creditors is another change introduced by the new Insolvency Law.

Last but not least, when exercising their office Directors hold fiduciary duties to the shareholders, the company, employees and creditors, which includes the duty to maximize value in connection with the inevitable break up of the company.

This commonly involves taking appropriate actions designed to maximize payment of the company's outstanding creditors. Officers and Directors who fail to carry out this responsibility may be subject to liability for breach of fiduciary duty.

III – CORPORATE LAW

Likewise, the Portuguese Companies' Code was recently amended through the introduction of new corporate governance rules, particularly related to the independence of Board members and respective responsibilities and duties.

For its significance, it is reproduced below the revised Article 64º of Portuguese Companies' Code:

"1 - *The managers and directors of the company must observe:*
a) Duties of care, revealing the promptness, technical knowledge and awareness of the company's activity adequate to his functions and using in that scope the diligence of a thoughtful and organized director; and
b) Duties of loyalty, in the company's interest, attending to the long term interests of the shareholders and taking in due consideration the interests of other relevant individuals to the company, as well as the company's employees, clients and creditors.
2 – The members of the corporate bodies with surveillance tasks shall observe duties of care, using to that effect high standards of professional diligence and duties of loyalty, in the company's best interests."

By disrespecting the above mentioned rules, Directors may be liable towards the company, its shareholders and other stakeholders.

The amendments to the Portuguese Companies' Code also brought new options regarding the governing structure of companies. Further to the existing two systems a third system based on the so called Anglo-Saxon model.

Thus, the option are to choose between the following:

a) The Latin Model, composed by a Board of Directors and a Supervisory Board;

b) The Anglo Saxon Model, which includes a Board of Directors, an Audit Commission and a Chartered Accountant;

c) The Two-Tier model composed of an Executive Committee, an Audit Committee a Chartered Accountant.

The new rules aim to change the decision-making process, providing more options for governing structures, reinforce the reporting duties of executive directors towards the corporate supervisory bodies and the hiring of independent directors and/or experts to be members of the bodies of the company.

IV – LIABILITY

Having described the Directors duties under Portuguese Insolvency and Corporate laws, this paper will now turn to the effects of the breach of said duties.

Civil Liability

The essential factors that lead to civil liability are (i) conduct (whether by action or omission), (ii) damage, (iii) illegality, (iv) culpability and (v) the factual link between the conduct and the damage.

There must be a damaging, illegal and culpable conduct of the Directors concerned. Yet, it is not sufficient to recognize that the Director proceeded in an objectively wrong manner. It is also necessary to prove that the illicit infringement was executed with malice (intention of causing damage or knowledge of the likelihood of such a result) or negligence (omission of the normal standard of diligence and care of a Director).

A Director becomes liable when, due to a culpable failure of fulfillment of his legal and contractual duties, resulting in damage and loss, the corporation's assets become insufficient to satisfy the credits, be it from the shareholders or third parties such as employees, tax authorities, social security or others.

In the case of the liability towards the company there is an inversion of the burden of proof – to be exempt the Director has to prove that he has acted without fault – it is still necessary to prove not only the damages but that certain legal or contractual duties were breached. The seriousness of the duty infringed is assessed not only by the damages caused but also by the nature of the duty infringed and the degree of fault of the Director.

It should however be said that the Portuguese Courts are reluctant to judge the merits of the decisions of the Directors. In fact the business judgement is conceived as belonging to shareholders, leaving to the Courts the legality judgement, and as such mismanagement and risk taking are not considered illegal.

There is still a long way to be paved by the courts, which will still need to provide guidance in respect of business judgement of the Directors, particularly under the new governance structure and business conduct rules.

When in case of bankruptcy, for the insolvency of the company has contributed, in a significant manner, any acts of Directors, the Court can hold those Directors jointly and severally liable for the debts of the company and order them to settle the respective liabilities.

The law deems that the Directors have contributed in a significant manner, to the insolvency of the company, when they have pursued any of the following actions: (i) destroyed or damaged the assets of the company or made them disappear wholly or in part; (ii) hidden or dissimulated the assets; (iii) created or aggravated artificially the liabilities and losses, or reduced profits, notably by being involved in crushing deals; (iv) disposed of the assets for their personal benefit; (v) conducted business activities under the corporate veil for their personal benefit; (vi) kept fictitious accountancy records or made accountancy documents disappear or deliberately failed to keep any accountancy records.

Where civil liability of the Directors arises under any of the above circumstances the Court may at any time impose on the Directors a deadline for satisfaction of the liabilities of the bankrupt company.

There are no caps on the liabilities of the Directors, which shall be liable for the actual damages caused. Clauses of exclusion or limitation of liability (either included in the Articles of Association or not) are null and void.

If there is a delegation of the management powers – on a Director – the remaining Directors, having a general duty of supervision upon the performance of the Director with delegated powers, may be hold liable for the latter's acts or omissions that cause damages whenever they were aware of the same and did not cause the intervention of the board in order to take appropriate measures.

Criminal Liability

Criminal liability is separated from the civil matters, and is dealt with under the Penal Code, which foresees the following distinct types of criminal conduct of a debtor or its Directors:

i) Fraudulent insolvency - a crime that includes the conduct of a debtor (the insolvent Company) that, with the purpose of prejudicing the creditors, (a) destroys or damages its assets or makes them disappear, (b) promotes or arranges for a fictitious reduction of the assets of the company, and (c) artificially creates or aggravates the losses or reduces the profits of the company - a conviction may lead to the imprisonment of the debtor for up to five years, where the company has actually gone bankrupt;

(ii) Non intentional insolvency - where the negligent conduct of the debtor (the insolvent Company) results in its bankruptcy – a conviction may result in a prison sentence of up to one year or a fine;

(iii) Creditors' facilitation - where the debtor (the insolvent Company), being aware of or at least being able to anticipate his bankruptcy and having the purpose of benefiting certain creditors in prejudice of the others, arranges for the settlement of debts which it was not bound to settle – a conviction may put the debtor in a prison for up to two years, depending on whether the company has to be placed in bankruptcy.

Directors may also be liable when having direct intervention on any of the above described acts.

V. CONCLUSION

Notwithstanding the abovementioned legal changes, perhaps no area has received less attention of the law than the governance of the troubled company.

Paramount to this lack of attention is the economic reality. Many troubled companies eventually colapse. When they do, Directors are likely to find their pre-insolvency decisions examined by various potentially hostile stakeholders armed with perfect hindsight.

While much has been written about the fiduciary duties of Directors of a company in bankruptcy (while the former Code was in force), a number of issues relating to duties of Directors during the pre-insolvency stage remain unsolved and we could even say are not yet embedded in Directors and even creditors and shareholder’s minds.

The development of legal doctrine should follow economic necessity. The current laws still do not aim at resolving tensions between duties owed to equity holders and duties owed to creditors and there is no Court experience in relation thereto.

The balance between duties owed by the board of a troubled company to the company itself, its shareholders and remaining stakeholders requires a high level of independency, capacity of judgement and management ability.

First of all, where a corporation is operating in the vicinity of insolvency, a Board of Directors is not merely the agent of the residual risk bearers, but owes its duty to the company.

In these terms, the Board has an obligation to the community of interest that sustains the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.

Such Directors shall recognize that in managing the business affairs of a corporation going concern, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

The prospect of insolvency brings along with it the need to change the ordinary conduct and management of the affairs of the company.

Directors of a company imminently insolvent no longer owe a major duty to stockholders who no longer have any viable economic interest in the company. Instead, Directors owe their duty to creditors and the company itself.

Simultaneously the nature of the Directors' duty also shifts from long term value maximization to preservation of existing asset value for eventual distribution to creditors.

Entrepreneurship and risk-taking, the hallmarks of corporate business activity, suddenly expose Directors to new potential liabilities**.** Assets preservation, the common ground for insolvency liquidators, will likely seem to be unduly conservative to the ordinary board.

Obviously, recognizing when insolvency has become imminent is critical. A failure to recognize this and to act accordingly may lead to personal liability for the board members.

The new Portuguese legal environment, which is in its early days, is aimed to reinforce Officers and Directors duties with the clear objective to ensure a deep change of minds as long as it demands Directors a most attentive, careful and technically skilful performance. Directors are given a major role in the companies' activity and respective performance shall be more and more submitted to creditors and shareholders survey.

We believe that this new spirit will ensure that Directors will be much more concerned with the economical and business health of the companies as their own destiny may be linked to the company's faith. Therefore Directors will be much more concerned with the rescue and reorganization of the company instead of simply allowing it to collapse when less favourable circumstances occur and starting up new companies as happened before.

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