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Duties and Responsibilities of Directors and Officers in Insolvency Situations
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Outline Paper

Portugal

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I. Introduction

A. The Portuguese Insolvency Code (in force since 2004) provides for new solutions regarding the responsibility of Directors.

Only actions specifically foreseen under the Code might be targeted for personal liability and any sanctions are subject to a court decision following a special procedure ancillary to the main insolvency proceedings (the so called “Insolvency Qualification Procedure”). Under the previous law, once a company was ordered bankrupt, the Directors would be immediately prevented from conducting any business activities, including to continue to hold any offices of Directors, regardless of the merit of their actions or if they made decisions in good faith under .

B. The Portuguese Companies Code (as changed in 2006) also innovated and has incorporated the US business judgment rule.

The Portuguese business judgment rule operates tough as an exclusion of liability by establishing that if the Director proves that he acted in “knowledgeable terms, free of any personal interest and accordingly to business reasonable criteria”.

C. It does not exist in Portugal a practice or tradition of seeking the liability of company’ Directors.

There are very few cases dealing with liability of Directors. The Portuguese Courts are reluctant to judge on the merit of the decision of the Directors, on the basis of the understanding that the evaluation of the merit of the decision in the specific circumstances shall be left with the shareholders; the role of the Court is to scrutinize the legality and the business judgment exercised by the Director or the risks taken cannot be hold illegal.

II. Duties and Responsibilities of Directors

A. The general rule is that the debts and liabilities of a company are only covered by the respective share capital, there being no liability of the Directors, unless the relevant legal requirements are met.

Directors have the general duty to act in a diligent manner and in the interest of the company, taking into account the interests of the stakeholders, such as shareholders, employees and creditors.

Directors have personal liability for their actions in respect of the company if they breach a fiduciary duty, their duty to consider the interest of the company as a whole instead of the interests of a particular shareholders or they duty to observe contractual and statutory provisions designed to protect creditors of the company, and the assets of the company became insufficient to meet the liabilities.
To hold a Director liable, it is necessary to prove the wrong-doing, that his action was illegal, either by breach of the law or a contractual provision, as well as the damages.

The “de facto” Directors can, in principle, also be liable under the same terms as the statutory Directors, although “de facto” Directors and their liability is only foreseen under the Bankruptcy Code.

B. There are specific rules applicable to the Director’s liability depending of the entity towards who the Director is liable.

1. The Director is liable towards the company for acts concerning the incorporation of the company, notably the wrong or insufficient information supplied during that stage as well as for damages caused for actions or omissions in breach of their statutory and contractual duties, unless they prove they have acted without fault. The burden of proof is reversed in this case, since it is the Director that has to prove lack of fault; however, the company still has to prove that the Director acted against contractual or statute based provisions and the damages caused as a result thereof.

Where liability arises out of execution of a board resolution, the Director that did not vote or voted against the matter, is excluded from liability, provided his vote has been recorded in the relevant minutes or was executed before a Notary Public (within five days from the meeting).

There are a number of specific causes of liability in the Companies Code, such as damages arising out of a merger deal, breach of non-competing duties, resignation without just cause, illegal acquisition of the company’s shares, etc.

2. The Director is liable towards the creditors of the company whenever, due to his faulty violation of statutory and contractual provisions aimed at the protection of the creditors, the assets of the company become insufficient to meet the respective liabilities. In an insolvency situation, the claim can be brought forward against the Director by the liquidator.

3. The Director is liable towards the shareholders and other third parties under the general terms of civil law.

4. The Director is liable for the tax and social security debts of the company when the debt was generated during his office or the payment date is subsequent to him taking office and it was the Director’s fault that the debt was not settled or the assets of the company are insufficient to settle the tax debt.

C. The general legal liability regime needs to be combined with the new business judgment rule, which has been incorporated as a clause of exclusion of liability. If the Director proves that he acted in “knowledgeable terms, free of
any personal interest and accordingly to business reasonable criteria” he cannot be hold liable for his actions.

The rationale behind the rule is that the Director is responsible for how he manages the business of the company; however, he is not liable for the results of his management, even when these are prejudicial to the company in the specific circumstances.

The rule further intends to avoid that the Court, while reviewing whether or not there was a breach of the duty of care, replaces the business judgment exercised by the Director by his own.

III. Responsibility of Directors in Insolvency Situations

A. In an insolvency situation, a Director can be in addition hold liable if his actions have caused or contributed in a significant manner to the insolvency of the company. The law deems such a conduct of a Director, when he pursued any of the following: (i) destroyed or damaged the assets of the company or made them disappear wholly or in part; (ii) hide or dissimulated assets; (iii) created or aggravated artificially the liabilities and losses, or reduced profits, notably by being involved in crushing deals; (iv) disposed of assets or conducted business activities under the corporate veil to his personal benefit; (v) kept fictitious accountancy records or made accountancy documents disappear or deliberately failed to keep any accountancy records.

B. The responsibility is limited to the Directors in office in the three years preceding the insolvency that with fault or bad faith have caused or aggravated the insolvency of the company or who breached their duty of loyalty.

The law does not establish which conduct of the Director is hold faulty or in bad faith. But it is safe to submit that a Director will be deem to have acted in bad faith when he is aware of the financial crisis of the company and takes actions or fails to take actions which demonstrate that he intends or doesn’t care with the insolvency situation or its aggravation. An example would be the Director that with the intention to cause the insolvency destroys or damages the assets of the company or made them disappear wholly or in part.

It may be also deemed that a Director acted with fault when he failed to place the financially stressed company under insolvency proceedings or did not comply with the obligation relating to the accountancy or to record the accounts with the relevant public entities.

There will be borderline situations, midway to bad faith and faulty conduct, where the Director foresees the insolvency as potential effect of his actions. An example would be the Director pursuing the business activities of the company at loss knowing that the odds are that the company will become insolvent.

A Director will breach his duty of loyalty when he disposed of assets or conducted business activities under the corporate veil to his personal benefit or
seized corporate opportunities. When as a result of such conduct the company turns insolvent, the Director will be hold liable.

C. The Director that made decisions in good faith and exercised reasonable business judgment and nonetheless the company became insolvent as well as the Director who acted with mere negligence will not be hold personally liable for the insolvency of the company.

The rationale behind this solution is acknowledgeable in the context of the diligent and careful Director and incorporates the business judgment rule. More controversial is the option to extend the exclusion of liability to the Director that acted with negligence.

Under the current legal regime, in an insolvency situation the Director that has pursued options to reorganize a company instead of placing it under insolvency proceedings will be safe if he is able to prove that he made decisions in good faith and exercised reasonable business judgment in the specific case. Likewise, the Director whose decisions are hold later as wrong or as incorrect business judgment will still benefit from the exclusion of liability. The personal liability will be targeted at those Directors whose decisions are unreasonable or in bad faith.

D. The Director who is hold personally liable for the insolvency of the company may face (i) a two to ten years ban from conducting any trade activities, including taking the office of Director; (ii) the loss of any credits that might have against the insolvent company; and (iii) be ordered to reimburse the company of any assets or monies received as compensation of those credits.

IV. Directors’ Insurance

Director’s Insurance is not legally required and actually is rare for Directors of small and medium size companies to have insurance. It is more common in listed companies or large companies.

For a specific type of company (S.A.) it is mandatory that the responsibility of the Directors is secured in any legal form up to an amount of € 5,000.

V. Cases dealing with Responsibilities of Directors

There are still very few liability judgments against Directors. Existing cases dealing with Director’s liability concern principally the following matters: (a) direct transfer of monies belonging to the company to the personal property of the Director; (b) payments to persons or entities not related to the company where the person was a Director; (c) failure to company legal requirements regarding the annual accounts; (d) non-authorized exercise of competing business activities with the company.
There is no case law regarding a situation where a Director has been targeted for personal liability for pursuing options to reorganize or restructure a company rather than to place it into insolvency proceedings.

But there is an increasing awareness regarding Director’s liability, to which the new Insolvency Code contributed, by reinforcing the liability of Directors in case of insolvency of the company – through the provision of the above referred “Insolvency Qualification Procedure” – and by giving exclusive standing to the liquidator to bring liability actions against a Director of an insolvent company.

Against this background, the new business judgment rule and the restrict insolvency liability legal regime provide a safe harbor to Directors of financially stressed companies when making the option to restructure instead of putting the company under insolvency proceedings.