Directors’ Liability for Insolvent Company’s Debts: Comparative Law Remarks

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Introduction
Directors’ Liability Towards Company’s Creditors

- different regulations in different jurisdictions
- common purpose (ratio legis):
- strengthening protection of a company’s creditors
Outline

- directors’ liability for an insolvent company’s debts: justification and theoretical background
- English law approach
- American law approach
- German law approach
- comparative remarks
Directors’ Liability for Insolvent Company’s Debts: Theoretical Background

- Bankruptcy as an element of market economy
- Bankruptcy as a problem for company’s creditors
- Bankruptcy proceedings as a tool to protect company’s creditors: not sufficiently powerful
- Prevention of bankruptcy as the best instrument to protect company’s creditors
- Liability of the insolvent company’s directors towards its creditors as a means of preventing insolvency of the company
Directors’ Liability for Insolvent Company’s Debts: Key Theoretical Problem

- company as a separate legal person:
  - English law: Salomon v. Salomon
  - German law: GmbH (§ 13 GmbHG), AktG (§ 1 AktG)
  - American law: corporation enjoys legal personality, LLC is not a legal person, but it is a subject of law
Directors’ Liability for Insolvent Company’s Debts: A Type of Piercing the Corporate Veil?

- directors’ liability for company’s debts – liability for the third person’s debt:
  - lifting/piercing the corporate veil, but aimed at directors
- the doctrine of piercing the corporate veil and its purpose:
  - protection of shareholders, but also of company’s creditors
Directors’ Liability for Insolvent Company’s Debts: English Law Approach

- justification of liability:
- fiduciary duties of directors
- duty of care
English Law Approach cont’d
Legal Instruments Against the Directors

- numerous instruments
- most important:
  - misfeasance proceedings (summary remedy)
  - fraudulent trading
  - wrongful trading
Misfeasance Proceedings
Authority

- sec. 212 Insolvency Act 1986:
- grounds:
- “[a director] has misapplied or retained, or become accountable for, any money or other property of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company.”
Misfeasance Proceedings

Procedure

- the application may be brought by: the official receiver or the liquidator, or any creditor
- the court may:
  - compel the director to repay, restore or account for the money or property or any part of it, with interest at such rate as the court thinks just, or to contribute such sum to the company’s assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty as the court thinks just
  - damages paid to the company’s assets
Missfeasance Proceedings

Examples

- selling company’s assets below their value (Re Travellers’ Chambers Ltd, [1985] 12 T.L.R. 529)
- not insuring company’s assets from fire (Re D’Jan of London Ltd, [1993] BCC 646)
- hidden payments from the assets of the company for a director (Gluckstein v. Barnes, [1900] AC 240)
English Law Approach
Fraudulent Trading

- sec. 213 of Insolvency Law:

“(1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.

(2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned are to be liable to make such contributions (if any) to the company’s assets as the court thinks proper.”
Fraudulent Trading

Key Features

- aimed at preventing fraudulent use of incorporation
- conditions of liability: insolvency of the company and fraudulent purpose of the business of the company
- locus standi: liquidator only
- compensate or punish: damages v. contributions
- not filing for insolvency: “sunshine test”
“Sunshine Test”
Re White and Osmond (Parkstone) Ltd

“[T]here is nothing to say that directors who genuinely believe that the clouds will roll away and the sunshine of prosperity will shine upon them again and disperse the fog of their depression are not entitled to incur credit to help them get over the bad time”
directors decided to loan more money even if they must have been sure that the company would not have been able to pay these debts (R. v. Grantham, [1984] 3 All ER 166 (CA); R v. Lockwood, [1986] 2 BCC 99, 333 (CA); Re Barnett (Augustus) & Son Ltd, [1986] BCLC 170)
Wrongful Trading

- introduced in 1986
- answer to practical difficulties with proving fraudulent purpose of directors’ actions
- aim: to prevent getting new loans by already insolvent company
- sec. 214 of Insolvency Law
Wrongful Trading
Conditions of Liability

- insolvency of the company
- insolvency proceedings is on
- the director knew or ought to have concluded that the company should not take more loans
Wrongful Trading: Procedure

- an application may be brought only by the liquidator
- sometimes regarded as weakness of this instrument
- as alternative a derivative action is proposed
- however, then some creditors may get more than others (first come, first served principle would apply)
Wrongful Trading
Scope of Liability

- “to make such contribution (if any) to the company’s assets as the court thinks proper” (sec. 241.1)
- contribution should relate to the value of company’s assets lost because of decisions of directors:
  - loss caused by bad weather conditions: directors are not liable (Re Continental Assurance Co of London plc)
  - there is no loss, although other conditions for wrongful trading liability are accomplished – no liability (Re Marini Ltd)
Wrongful Trading
Who may be liable?

- potentially liable: every director:
- sleeping director
- shadow director
- *de facto* director
Wrongful Trading

Conditions of Exemption from Liability

- out of the scope of managerial duties
- but:
  - this exemption from liability is exceptional, because all directors are obliged to take care of financial situation of a company (Re DKG Contractors Ltd)
  - action to limit the creditors’ loss
  - stepping down is not enough
Wrongful Trading: Advantages

- The consciousness that a director may incur personal liability is, in practice, often sufficient to encourage directors to take professional advice – which should lead to a better outcome for creditors.

- Potentially creditors may be paid more out of the estate of the company if directors have to pay contributions to the company’s assets.

- Development of D&O insurance.
Practical Obstacles With Application of Wrongful Trading

- lack of a company’s assets to pay proceedings costs
- reluctance to spend remaining company’s assets for costs of the proceedings instead of payment to the creditors
- too flexible regulation – uncertainty as to the results of suing a director
- to date in practice applied only to small companies
English Law Approach

Conclusions

- the number of legal instruments do not guarantee the appropriate level of protection of an insolvent company’s creditors

- weaknesses of these instruments:
  - burden of proof
  - lack of creditors’ direct (at least derivate) action

- some important amendments needed to make these instruments more important in practice
Directors’ Liability for Insolvent Company’s Debts: American Law Approach

- American company law – state law
- types of companies:
  - corporations (different types, e.g. close, open, S, C)
  - LLC (limited liability companies)
- American insolvency law – federal law
- no statutory rules on director’s liability for an insolvent company’s debts
Deepening Insolvency Doctrine

- developed by case law only
- Patterson v. Franklin (1896) regarded as its very first application
- originally directed against shareholders and concurrent to doctrine of piercing the corporate veil
- the term first used in 1983 (Schacht v. Brown, 711 F.2d 1343)
Deepening Insolvency

Key Features

- **ratio legis**: to prevent doing business by insolvent companies
- directors’ duty to file for insolvency – flexible assessment
- regard as a type of breach of business judgment rule by keeping in business an insolvent company to the detriment of business partners
The Nature of Deepening Insolvency Doctrine

- tortuous (delict) liability

- Kittay v. Atlantic Bank of New York (In re Global Service Group, LLC), 316 B.R. 451:

  “fraudulent prolongation of a corporation’s life beyond insolvency, resulting in damage to the corporation caused by increased debt”
Deepening Insolvency: Procedure

- only the company may sue its directors
- particularly bankruptcy trustee is not in a position to sue directors on behalf of the company’s creditors (US Supreme Court case: Caplin v. Marine Midland Grace Trust Co, 406 U.S. 416)
Deepening Insolvency Doctrine
Who may be liable?

- very broad scope
- directors
- financial advisors (Re Flagship Healthcare, 269 B.R. 721)
Deepening Insolvency Practical Problems

- burden of prove
- “old creditors” v. “new creditors”
- lack of direct action of creditors and their less effective protection
- divergent case law in different jurisdictions (states): total rejection of the doctrine in some states (e.g. Delaware)
American Law Approach Conclusions

- unified system of creditors’ protection in case of insolvency of a company for all types of companies
- no statutory regulations – legal instrument purely developed by case law
- not filing for an insolvency as a tort
Directors’ Liability for Insolvent Company’s Debts: German Law Approach

- principle:
  - German companies are separate legal persons which are exclusively liable for their debts
- directors’ liability is exceptional
- two legal instruments:
- *Insolvenzverursachungshaftung*:
  - applies to Gesselschaften mit beschränkter Haftung (GmbH) only
- *Insolvenzverschleppungshaftung*:
  - applies to both: GmbH & Aktiengesellschaften
Insolvenzverursachungshaftung

§ 64 GmbHG:

directors are obliged to compensate the company for:

1. payments made after the company has become illiquid (over indebted)
2. payments to shareholders if these led to the company becoming illiquid

liability not towards the creditors, but towards the company (*Innenhaftung*)

exemption from liability:

business judgment rule
§ 15a InsO:
liability towards the creditors (*Außenhaftung*)
liability prerequisites:
a company’s insolvency
not filing a request to open (begin) insolvency proceedings on time
Insolvenzverschleppungshaftung
Who may be liable?

- only formally appointed directors
- excluded liability of:
  - shadow directors
  - de facto directors
The Nature of Liability

- tortuous liability:
- resulting from breaching statutory duty (to file a request for opening insolvency proceedings in time)
- regular rules on tortuous liability apply, e.g. not filing must be intentional or an effect of negligence
Insolvenzverschleppungshaftung

Scope of Liability

Categories of Creditors

- the old creditors v. the new creditors
- contractual creditors v. tortuous creditors
Insolvenzverschleppungshaftung

Procedure

- not regulated individually
- general rules on torts apply
- each creditor can sue director(s) individually
- heavy burden of proof: a creditor has to prove loss, its value, intentional or negligent breach of the § 15a of Insolvency Law, causal link between the breach and loss
- if successful, damages is paid directly to the creditor (not to the company’s assets)
Insolvenzverschleppungshaftung
Practice

- rarely happens and rarely successful:
- too heavy burden of prove
German Law Approach

Conclusions

- formally the directors are not liable for company’s debts
- two separate legal instruments
- different categories of creditors
- a creditor decides who should be sued (one, few, or all directors)
- no special liability regime: tortuous liability
- low practical effectiveness due to heavy burden of proof on creditors
Polish Law Approach

- not perfect regulation
- very effective in practice
- plenty of lawsuits against directors
- frequently directors are obliged to pay damages to creditors
Polish Law Approach
Bases of Directors’ Liability

- German model of regulation
- two separate legal instruments
- art. 299 of Commercial Companies Code
- art. 21 of Insolvency Law
- only the art. 299 of CCC matters in practice
Art. 21 of Law on Insolvency and Reorganization

- applies to all types of companies
- basis for liability:
  - not filing for insolvency on time
  - tortuous liability
- each creditor may sue every director individually
- heavy burden of proof, but presumption of intentional/negligent breaching of the statutory duty
Art. 299 of CCC

- restricted to limited liability companies
- individual action of every creditor potentially against every director
- burden to proof: enforcement against the company proves to be ineffective, the company’s debts
- presumptions: loss and its value (all unpaid company’s debts), not filing for insolvency on time – breaching the statutory duty, causal link between the breach and the loss
Polish Law Approach: Conclusions Practical Success

- every creditor can sue directly
- not derivative action: damages is paid directly to creditors (an incentive to sue)
- scope of liability: all unpaid debts of the company
- low burden of proof: presumptions of loss, causal link, and intentional/negligent breaching of law
Conclusions: Comparative Law Remarks

- Insolvency proceedings remains the most important legal regime to deal with insolvent company’s creditors.
- Difference concerning the possibility of directly suing the directors by creditors.
- Directors are liable for breaching a duty: either fiduciary duty, duty of care, or statutory duty to file for insolvency on time.
Conclusions cont’d
Comparative Law Remarks

- liability of directors for an insolvent company’s debts may be truly efficient tool to protect the company’s creditors, particularly with regard to small and medium size companies – two conditions should be accomplished:
  - incentives for creditors to sue directors
  - light burden of proof
Conclusions

- directors’ liability for insolvent companies’ debts as inevitable element of legal system
- directors’ liability towards a company’s creditors in case of the company’s insolvency requires some improvements in every jurisdiction:
- comparative law studies could help!
Thank you very much for your attention!