The Liability of Advisors and Office-Holders in Insolvency and Restructuring Cases

Dr. Christof W. Schiller, Moderator
anchor Rechtsanwälte; Mannheim, Germany

Michael Broeders
Freshfields Bruckhaus Deringer LLP; Amsterdam, Netherlands

Yves Brulard
DBB Law; Brussels, Belgium

Robert M. Fishman
Shaw Fishman Glantz & Towbin LLC; Chicago, USA

Nick Moser
Taylor Wessing LLP; London, England

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Pre insolvency filing liability: liability in the twilight zone

1. Is there a pre-filing liability risk for directors towards creditors?
2. Are there any specific triggers for pre-filing liability i.e. late filing?
3. Is there any criminal liability, is it relevant in practice in the pre-filing context?
4. Does the pre-filing liability that exists in your jurisdiction limit or impede out of court restructurings?
5. Are there any safe havens or other mitigants against liability that may arise during the pre-filing phase?

Liability of directors within the context of in court restructurings

1. Does management continue to be in function following a filing?
2. Does management require approval of the court and what are the consequences for failing to obtain approval?
3. If management stays in function, can it act independently and what are the consequences of the commencement of the procedure for the liability of the directors?
4. If an office holder is appointed, can it act independently? Or does it require court approval?
5. Can the office holder be held liable by creditors or other third parties?
6. Can management be held liable by creditors or other third parties when management continues to act for the debtor in possession?

The after math: allocating the “Blame”

1. Are directors held personally liable in your jurisdiction?

2. Who commences the actions the joint creditors, or a particular creditor or group of creditors only, or ace actions commenced by equity holders?

3. For what damages can directors be held liable?

DIRECTOR LIABILITY UNDER DUTCH LAW

An introductory overview

Michael Broeders
Freshfields Bruckhaus Deringer LLP
Strawinskylaan 10, Amsterdam the Netherlands
Michael.Broeders@freshfields.com
31 (0) 20 485 7661

American Bankruptcy Institute
International Insolvency and Restructuring Program
Amsterdam, Netherlands
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1. INTRODUCTION

1.1 Personal liability of a director of a company pursuant to Netherlands corporate or civil law, regardless whether the company's legal form is a private limited company (*besloten vennootschap met beperkte aansprakelijkheid* or *BV*) or a public limited company (*naamloze vennootschap* or *NV*), can be divided into the following categories:[1]

(a) directors' liability based on violation of statutory duties;

(b) directors' liability based on tort; and

(c) directors' liability for taxes and premiums.

These categories will be described in further detail in chapters 2 to 5 of this paper respectively. Chapter 6 of this paper provides for an overview of the scope of personal liability of persons involved with a company other than statutory directors.

2. DIRECTORS' LIABILITY PURSUANT TO IMPROPER TASK PERFORMANCE

2.1 Each director has a duty towards the company to properly perform his/her duties as a director of the company. This is provided in section 9 of book 2 of the Netherlands Civil Code (***NCC***). As a general rule, one may expect from a director that he/she is sufficiently equipped and qualified to perform his/her duties properly and that he/she will carry out his/her duties diligently, accurately and with due observance of the company's objectives and interests. A director therefore cannot justify his/her actions by arguing that he/she did not have the capacities required.[2]

2.2 A failure to properly perform the directors' duties, also referred to as improper task performance (*onbehoorlijke taakvervulling*), may result in directors' liability. A claim for directors' liability may only be invoked by the company itself. In practice this means that generally a claim will only be launched once the director that performed its management task in an improper manner has been removed. When the company has gone bankrupt, the bankruptcy trustee shall be exclusively authorized to commence an action for improper task performance against the director(s) on behalf of the company.

2.3 Liability for improper task performance will arise if:

(a) the director has not properly performed his/her managerial duties;

(b) this has resulted in damage to the company; and

(c) taking into account all circumstances, the director can be seriously blamed (*ernstig verwijtbaar*) for this.

2.4 The statutory starting position is that in order to manage a business properly a director should have sufficient discretion to manage the day to day activities and determine the strategy of the company as he/she deems fit, even if this means that the company will take risks and face uncertainties. Consequently, a court may only assess the director's task performance by comparing to what may be expected from a careful and reasonably competent director[3] and only hold a director personally liable to the extent he/she can be seriously blamed in respect of the performance of his/her duties.[4]

2.5 Whether serious blame (*ernstige verwijtbaarheid*) can be established, depends on all circumstances of the case, such as the size and nature of the company's activities, the risks attached to these activities, the allocation of responsibilities between the directors on the board (if any), any guidelines applicable to the management board, the information available or that should have been available at the time of the performance of those duties, and the level of comprehension and judgement that may be expected from a director who is suited for and fulfils his/her duties diligently.[5]

2.6 Serious blame is however presumed present in case a director fails to comply with the provisions of the company's articles of association, particularly those aiming to protect the company[6]. This includes in any event the provisions in the articles of association of the company dealing with conflicts of interests between a director and the company. (Section 2:129/239 sub-paragraph 6 NCC).

2.7 To determine whether the task performance constitutes improper task performance, the relevant circumstances as prevailing at the time of the act must be considered. Any judgment with the benefit of hindsight must be avoided.

2.8 The liability is for the actual damage incurred by the company. The amount of damages may also include damages caused to the equity.

2.9 A director may also have a contractual relationship with the company. This may be an employment contract or a management contract. A director performing his/her assignment improperly, in such a way that it can be considered non-performance of his/her duties under the contract between himself and the company can be held personally liable by the company for damages that have arisen from the non-performance of his/her contractual obligations. Unless the non-performance cannot be attributed to that director.

2.10 The claims on behalf of the company for improper task performance, as well as any contractual claims against the director, become time barred after five years as of the moment that the company could have commenced the action. This will typically be the case as of the moment that the director or the directors that caused the damage are no longer on the board of the company.[7]

Examples of improper task performance

2.11 The courts have established improper task performance in various different circumstances. For example, where a director:

(a) subordinated the company's interests to his/her own interests;

(b) failed to intervene in a transaction when he/she knew or should have known that as a result of the transaction, the liquidity and solvency of the company would be seriously at risk;

(c) took decisions with far-reaching financial consequences, without proper preparation and without taking care that the arrangements were properly recorded in writing;

(d) withdrew means from the company (e.g. for private use);

(e) effected transactions on behalf of the company with related companies which cannot be considered arms' length transactions, which cause financial disadvantage to the company;

(f) provided loans on behalf of the company to parties of doubtful creditworthiness without adequate collateral;

(g) effected transactions on behalf of the company which are ultra vires or which infringe on internal guidelines;

(h) caused the company to grant a non-interest bearing loan to a relative;

(i) appointed himself as estate agent for and received a fee from the company in respect of a transaction already concluded by the company;

(j) granted a sizeable loan to the sole shareholder or to a supervisory director of the company without any security;

(k) failed to adequately supervise the employees as a result of which the employees stole monies from the company; and

(l) failed to take out customary insurance policies.

2.12 Violation of certain explicit statutory duties may also lead to directors' liability for improper task performance. These duties of a director for example include:

(a) The duty to record the company's financial position in an appropriate manner, to prepare financial reports and to keep the company's books and records;[8]

(b) to the extent applicable, failing to obtain approval of the supervisory board (or meeting of shareholders) for certain proposed board resolutions;[9] and

(c) failing to publish the company's annual accounts;[10]

Directors jointly and severally liable; exculpation

2.13 Managing a company is a collegiate activity of the members of the management board and, as a consequence, leads to joint responsibility. If there has been improper task performance, then each of the members of the management board may be criticized and as the case may be, suspended or dismissed by the body of the company that has the authority to do so (usually the general meeting of shareholders).

2.14 Furthermore, the joint responsibility in principle also leads to joint and several liability of each director in case of a failure to perform certain duties that fall within the assignment of two or more directors, unless an individual director is able to exculpate himself from such liability.

2.15 A director may be able to exculpate himself or herself on the following grounds:

(a) He/she cannot be blamed for improper management; and

(b) He/she attempted to prevent the negative consequences of the improper management from happening (e.g. serious attempts afterwards to undo a decision taken by his/her fellow-managing directors in his/her absence (for example, because of illness or holiday)).

2.16 These grounds for exculpation require a director to prove that he/she cannot be seriously blamed and that he/she has not been seriously negligent in taking measures. In practice directors are not likely to be often able to successfully exculpate themselves. In particular the general strategy and also the general financial management policy are considered to belong to the responsibility of each director, regardless of any internal task allocation. In practice the possibility to exculpate is more likely to be effective for none executives, in case the company has a one tier board.

Discharge

2.17 In principle, a director cannot be held liable towards the company in respect of his/her performance of the duties for which he/she has been granted a valid discharge by the company's general meeting of shareholders. A discharge operates as an exemption or release from liability by the company. Pursuant to case law, this exemption of directors' liability will only be valid and upheld in court proceedings to the extent it has been granted on the basis of correct information made available to the company's general meeting of shareholders.[11] Also a discharge decision may be nullified by the court.[12]

2.18 Finally, there are two specific circumstances that statutorily can result in directors' liability:

(a) one or more interim and/or annual financial reports of the company provide(s) a misleading representation of the financial condition of the company[13]; and

(b) the company issuing or disclosing a misleading prospectus to the public.

3. DIRECTORS' LIABILITY IN CASE OF BANKRUPTCY TOWARDS THE BANKRUPTCY ESTATE

3.1 In the event of bankruptcy of a company, if there has been manifestly improper management (*kennelijk onbehoorlijk bestuur*), the bankruptcy trustee can hold the directors liable for the deficit in the bankruptcy estate. The deficit in the bankruptcy estate is the amount of unpaid creditors that cannot be paid from the proceeds of the company's assets following liquidation of the assets.[14]

3.2 The action on the basis of manifestly improper management is exclusive to the bankruptcy trustee. The bankruptcy trustee may not assign the (right to) claim[15]. Contrary to a claim on the basis of section 2:9 NCC or a claim in tort (which will be further discussed below), which may both be assigned.

3.3 Liability will arise if at any time during the three-year period preceding the bankruptcy:

(i) the management board has managed the company in a manifestly improper manner; and

(ii) this is likely to have been an important cause of the bankruptcy.

The bankruptcy trustee has to prove that conditions (i) and (ii) have been satisfied.

Ad i. manifestly improper management

3.4 The bankruptcy trustee must prove that the management board can be seriously blamed for the manifestly improper management in order for liability to occur. For this, the actions of the management board or of an individual director must have been thoughtless, reckless and irresponsible. This must be assessed on the basis of the circumstances that existed at the time of the alleged improper management, disregarding any benefit of hindsight. Clearly, this in practice in litigation creates issues when assessing the actions of directors afterwards due to hindsight bias problems.

3.5 The word "manifestly" implies that directors are granted considerable discretion with respect to managing the business and dealing with the risks involved. Unintentional mistakes and management errors do not in themselves constitute manifestly improper

management. The legislator intended to create a high hurdle, with a view to awarding directors a fair margin of discretion and also to protect them against being held liable to easily.

3.6 The test for determining whether a management act must be considered manifestly improper is when no rational-thinking director, which has sufficient expertise and experience – under the same circumstances – would have acted in the same manner.[16]

3.7 Legislative history and case law provides examples of manifestly improper management, such as:

(a) taking decisions with far-reaching financial consequences without proper preparation;

(b) not investigating the creditworthiness of contracting parties at the time of entering into important transactions that have a considerable impact on the company's business;

(c) not timely hedging for clearly foreseeable risks;

(d) not accurately and fully informing supervisory directors;

(e) acting in violation of the company's objective or contrary to the interest of the company;

(f) cooperating with an important transaction or repaying a debt when this constitutes fraudulent preference;

(g) using funds of the company, other than for the benefit of the company;

(h) paying dividends when such payments are in violation of the law and/or the articles of association of the company or such payments should be considered economically irresponsible;

Ad ii. Likely to be an important cause of the bankruptcy

If the bankruptcy trustee has proven that the management board has managed the company in a manifestly improper manner, then the bankruptcy trustee must establish that the manifestly improper management is an important cause of the bankruptcy. In other words, it will be sufficient for the bankruptcy trustee to make probable a reasonable case of cause and effect. 'Important cause' in this perspective means more than 'just one of the causes of the bankruptcy'. It is also insufficient that the improper management was only a condition required for the bankruptcy to occur.[17]

Manifestly improper management is presumed when the books and records of the company were not maintained properly or when the financial reports were not filed in time

3.8 Manifestly improper management is deemed to have taken place and is presumed to constitute an important cause of the bankruptcy, if at any time during the three-year period preceding the bankruptcy:

(a) the administration of the company has not been kept in compliance with statutory requirements (the administration must enable that all assets and liabilities of the company can be determined at any time); or

(b) the annual accounts and other financial information required of the company has not been filed timely with the Chamber of Commerce.

3.9 In these instances, the directors shall be liable unless they can prove that the manifestly improper management did not constitute an important cause of the bankruptcy. This requires the directors to prove that there was another cause, other than the faulty administration or late filing that caused the bankruptcy. However, in practice a bankruptcy trustee shall generally not commence an action if the trustee is of the view that the bankruptcy was indeed caused by another cause than the late filing or the faulty administration.

3.10 In addition an individual director may be able to exculpate him or herself. The same standard as described in paragraph 2.15 of this paper applies.

4. DIRECTORS' LIABILITY BASED ON TORT

4.1 Director's liability can also be based on tort. The following requirements must be satisfied for an action based on tort against a director:

(a) the act by the director must infringe on a right or breach a duty imposed by law or a duty of care;

(b) the director can be blamed for the act;

(c) the claimant must have suffered damages[18];

(d) the damages are caused by the relevant act (i.e. there is a causal relationship between the damages and the unlawful act); and

(e) the purpose of the right or duty that has been infringed on or breached must be to protect the interests of the claimant.

4.2 For assessing whether a director can be held personally liable, the decisive test is the requisite level of knowledge and judgement that may be expected of a director, in

respect of its actions and the resulting damages that were foreseeable for third parties.[19]

4.3 Also, there must be serious personal blame for the individual director that is being held liable.[20]

4.4 Both individual creditors or groups of creditors and the trustee in bankruptcy acting on behalf of the joint creditors may commence actions against directors on the basis of tort. An action by the bankruptcy trustee must be dealt with first by the court and the action by an individual director may be suspended during that time.

4.5 In principal derivative suits by shareholders on the basis of tort against directors that caused damages to the company are not possible. The presumption is that the company reclaims the damages itself, thereby also compensating shareholders.[21]

Examples of acts that have been qualified as a tort

4.6 The Dutch courts have established directors' liability based on tort. For example, where:

(a) a company did not pay its debts because its director prevented such payments;[22]

(b) a director on behalf of the company entered into new commitments while he/she knew or should have known that the company would not be able to meet these commitments and also that the company offered insufficient recourse for the resulting damages;[23]

(c) a director falsely conveyed an impression of creditworthiness of the company;[24]

(d) a director prevented the company from meeting its contractual obligations.[25]

Liability towards creditors, when in the twilight zone

4.7 Directors liability on the basis of tort in the twilight zone is an important point of attention for directors when the business is in financial distress. In broad terms, when acting on behalf of a company that is on the brink of insolvency, liability may in particular arise in the following situations:

(i) where the director on behalf of the company enters into a new commitment while he/she knew or reasonably should have known that the company would not be able to meet such commitment (within a reasonable period of time) and that the company would not offer sufficient recourse to the injured counterparty for any damage caused; and[26]

(ii) where the director allows or procures that the company does not meet certain contractual obligations and consequently the counter parties incur damages[27];

Ad i.

4.8 It is important to note that this situation will arise if and to the extent that the relevant director knew or should have known that a certain transaction would turn out wrong and that consequently the company would not be able to meet its commitments and not offer sufficient recourse for the resulting damages.[28] Entering into a transaction with the knowledge that there is a risk of the company not being able to meet its commitments is not sufficient. Also directors' liability on the basis of tort of a director should not occur in case the counterparty to a transaction, despite knowledge of the insecure financial status of the company, carried on doing business with the company.[29]

Ad ii.

4.9 When a company has an existing relationship with a party, there may well be a duty of care of the directors of that company vis-à-vis that party, for instance where there is a serious possibility of the company not being able to meet its financial obligations, and payment of an (inter company) creditor is effected and the claims of other creditors are left unpaid.[30]

4.10 If the board of the company is comprised of more than one person, in case of liability in tort of one director, the other director may only be held personally liable to the extent that this director can also be seriously blamed. This would typically require the other director to also be very closely involved in the tortious act primarily committed by the co-director.[31]

Damages

4.11 A director held personally liable for an act which is a tort has to compensate the party that suffered damages that are the result of the act and that may reasonably be attributed to the act as a result.[32]

4.12 The amount of damages in respect of a tort may exceed the amount of the bankruptcy deficit, as it also may include, lost profit and also damages caused to the equity of the company.

5. LIABILITY FOR TAXES AND PREMIUMS

5.1 On the basis of statutory provisions, the tax authorities and the social security board may hold the directors of a company jointly and severally liable for certain unpaid taxes and social security contributions.[33]

Duty to notify

5.2 Any company subject to Netherlands corporate income tax is obliged to forthwith notify the tax authorities and the social security board in writing that it will not be able to pay VAT, wage withholding tax or certain other taxes, excise duties or social security contributions. The notification must be made within two weeks after the date on which the aforementioned taxes, duties or contributions should have been paid.[34]

Liability if notified

5.3 If the company has timely notified, the directors of the company will only be jointly and severally liable alongside the company for unpaid taxes, duties and social security contributions if the relevant authority can establish that the non-payment of the taxes, duties or social security contributions that are due is the consequence of their manifestly improper management during the period of three years preceding the date of notification.[35]

Liability if not notified

5.4 If the company has not timely notified, it is assumed that the non-payment is the consequence of manifestly improper management as mentioned above. An individual director is only allowed to demonstrate that the non-payment was not caused by his/her manifestly improper management if he/she proves that he/she cannot be blamed for the failure to timely notify the relevant authorities.[36]

5.5 If there has not been a timely notification and a director has no valid excuse for the failure to timely notify – or if he/she has such an excuse, but he/she cannot demonstrate that the non-payment was not caused by his/her manifestly improper management of the company – then he/she is jointly and severally liable with the company for those taxes, duties and social security contributions that have not been paid over the three year period prior to the bankruptcy date.[37]

Pension premiums

5.6 If the company participates in an industry-level pension fund, a similar obligation to notify the pension fund and a similar liability for unpaid pension premiums, may exist.

6. DIRECTORS' LIABILITY OF SUPERVISORY DIRECTORS AND SHADOW DIRECTORS

Supervisory directors

6.1 The aforementioned categories of directors' liability, except liability for taxes *mutatis mutandis* apply to supervisory directors. Although a different standard that is tailored to the function of supervisory director applies.

6.2 The main statutory duty of a supervisory board is to supervise and advise the management board. Accordingly, liability for supervisory directors may arise in case of:

(a) improper performance of its duty to supervise the management board;

(b) providing ill-considered and incorrect advice to the management board; and/or

(c) negligence in respect of the performance of certain specific duties.

6.3 Furthermore, a supervisory director may also be held liable as if he/she were a member of the management board in case he/she performs certain managerial duties (based on the statutory authorisation or a resolution of general meeting of shareholders).[38]

Shadow directors

6.4 A person who is factually in charge, but not formally appointed as a director, a so-called shadow director, can be held personally liable for the deficit of the bankruptcy estate or for certain tax liabilities of the company as if he/she were a director. Accordingly, paragraphs 3.1 to 3.8 (liability in case of bankruptcy) and 5.1 to 5.6 (liability for taxes and premiums) of this paper also apply to shadow directors.

6.5 The requirements for qualifying as a shadow director are:

(a) a person not appointed as director, has in fact (co-)managed i.e. (co-) determined the policy of the company;[39] and

(b) that person has directly interfered with the management of the company and imposed his/her will on the statutory managing board.[40]

6.6 Persons (co-)managing the company, without being appointed as director, but acting on the basis of a power of attorney or statutory authority,[41] will not be considered shadow directors as long as these persons act within their (statutory) authority.

Persons acting as interim directors[42]

6.7 The articles of association or the general meeting of shareholders may authorise certain persons to perform certain managerial duties on an interim basis without being appointed as director. With respect to directors' liability, these persons will be treated as if they were formally appointed as directors, it being understood that directors' liability of these persons will be limited to the performance of the managerial duties they are authorised to perform.

6.8 Examples are:

(a) interim directors (e.g. in case of serious illness or suspension of a director);

(b) none-executives or supervisory directors or special representatives appointed by the general meeting of shareholders (e.g. in case of a conflict of interest between a director and the company).

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[1] This note does not cover listed entities, nor financial institutions that are regulated pursuant to the Dutch Financial Markets Supervision Act. This note further assumes that the centre of main interest of the company is located in the Netherlands.
[2] HR 10 January 1997, NJ 1997, 360 (Staleman/Van de Ven)
[3] HR 29 June 2009, NJ 2009, 418 (see opinion of *Advocaat-Generaal* Timmerman)
[4] HR 10 January 1997, NJ 1997, 360 (Staleman/Van de Ven). The same criterion of 'serious blame' already applied to the determination of a director's liability pursuant to failure in performance of obligations under an employment contract (HR 4 February 1983, NJ 1983, 543. Also: HR 1 November 1991, NJ 1992, 32 and HR 20 March 2001, JAR 2001/127)
[5] HR 10 January 1997 JOR 1997, 29. Also HR 11 June 1999, NJ 1999, 586, HR 10 December 1999, NJ 2000, 6, JOR 2000/11 and HR 29 November 2002, nr C01/096HR, JOR 2003/2
[6] HR 29 November 2002, NJ 2003, 455 Berghuizer Papierfabriek, HR 20 June 2008, NJ 2009, 21 (Willemsen Beheer/ NOM N.V.); in aforementioned cases, the Supreme Court determined that the serious blame requires for directors' liability is assumed in case a managing director has acted in violation of certain provisions of the company's articles of association insofar these provisions aim to protect the company's (or the shareholders') interests, unless the managing director is able to provide sufficient facts and circumstances evidencing that his/her acting does not constitute serious blame.
[7] HR 4 May, 2012, JOR 2012/349
[8] 2:10 NCC, District Court Central Netherlands, 19 June 2014, JOR 2014/124 and HR 10 October 2014, JOR 2014/327
[9] 2:164 NCC
[10] 2:395 NCC. See also HR 1 November 2013, JOR 2014/336.
[11] HR 10 January 1997, NJ 1997, 360 (Staleman/Van de Ven) and HR 25 June 2010, JOR 2010/227 (De Rouw/Dingemans q.q.)
[12] HR 20 October 1989, NJ 1990, 308 (Ellem), OK 27 May 2010, JOR 2010/189 (PCM)
[13] 2:139/249 NCC
[14] 2:138/248 NCC
[15] HR 7 September 1990, NJ 1991, 52 (Den Toom/De Kreek)
[16] HR 7 June 1996, NJ 1996, 695; HR 8 June 2001, JOR 2001/171 / NJ 2001, 454 r.o. 3.7.
[17] HR 24 February 2014, JOR 2014, 122
[18] In case the facts of the matter may provide for both a claim based on unlawful act and fraudulent conveyance, it may be interesting for the claimant to review the different results. A successful claim based on fraudulent conveyance will result in the nullification of the relevant act and the subsequent obligations of all parties to undo the relevant legal act while a successful claim based on an unlawful act will result in the obligation to pay the damages, the amount of which may take into account *inter alia* possible loss of profit and circumstances that my be imputed on the claimant.
[19] i.e. the knowledge that may be expected from a careful and competent managing director in a comparable situation. Consequently, the claimant does not have to proof that such knowledge was actually present with the accused managing director. See also HR 5 September 2014, JOR 2014/325.
[20] HR 5 September 2014, JOR 2014/296 (Tulip Air)
[21] HR 2 December 1994, NJ 1995, 288 (Poot/ABP)
[22] HR 8 January 1999, NJ 1999, 318, HR 3 April 1992, NJ 1992, 411
[23] HR 6 October 1989, NJ 1990, 286 (Beklamel) and e.g. HR 17 June 2005, JOR 2005/234, where the Supreme Court decided that the managing director was personally liable because the company had not fulfilled its commitments under a settlement agreement entered into with a former employee while the managing director already knew or should have known that the company would not be able to meet these commitments when entering into the settlement agreement.
[24] HR 26 June 2009, NJ 2009, 418
[25] HR 26 March 2010, JOR 2010, 127
[26] HR 6 October 1989, NJ 1990, 286 (Beklamel) HR 5 September 2014, JOR 2014, 325 (RCI Financial Services/Kastrop) m.nt. S.C.J.J.Kortmann

[27] HR 18 February 2000. NJ 2000, 295
[28] HR 14 November 1997, NJ 1998, 270
[29] Rb Rotterdam, JOR 2002, 99 and Hof Leeuwarden 24 May 2006.
[30] HR 21 December 2001, NJ 2005, 96
[31] HR 8 January 1999, NJ 1999, 318
[32] Hof 's-Hertogenbosch, JOR 2010, 298 (Palm/Mares). See also Court of Appeal Amsterdam, 3 June 2014, JOR 2015, 163
[33] Art. 36 Collection Act (*Invorderingswet*)
[34] Art. 36 sub 2 Collection Act. (The definition '*onverwijld*' means two weeks after the date on which the aforementioned taxes, duties or contributions should have been paid).
[35] Art. 36 sub 3 Collection Act.
[36] Art. 36 sub 4 Collection Act.
[37] Art. 36 sub 4 Collection Act.
[38] Reference is made to paragraph 6.8(b)
[39] HR 24 May 2002, NJ 2002, 413
[40] HR 17 November 2006, RvdW 2006, 1082 (Lebon/Hoogendoorn q.q.); HR 2 September 2011, RI 2012,1 (Atlanco/Van Schuppen q.q.)
[41] e.g. persons working within the company who have been granted certain (limited and specified) powers to represent the company, or the supervisory board or general meeting of shareholders who are performing managerial tasks due to statutory provisions
[42] 2:151/261 NCC

Governing Principles of Director Liability under United States Law

Robert M. Fishman
Allison Hudson
Shaw Fishman Glantz & Towbin LLC
312 North Clark Street, Suite 800
Chicago, Illinois 60654
(312) 541-0151
rfishman@shawfishman.com
ahudson@shawfishman.com

American Bankruptcy Institute
International Insolvency and Restructuring Program
Amsterdam, Netherlands
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I. General Bases for Director Liability[1]

A. *Corporate Entity Distinct from Directors*. A corporation is a separate and legally distinct entity from its managers and directors. *See Gottlieb. Sandia Am. Corp.*, 452 F.2d 510, (3d Cir. 1971)("A duly organized business corporation enjoys an identity separate and apart from its stockholders, directors, and officers.").

a. General Rule: Directors and officers of a corporation, in general, are not personally liable for the debts of a corporation. *See, e.g.*, *Musikiwamba v. ESSI, Inc.*, 760 F.2d 740, 753 (7th Cir. 1985)("General corporation law is clear that personal liability for a corporation's debts cannot be imposed on a person merely because he is an officer, shareholder, and incorporator of that corporation."); *United States v. Van Diviner*, 822 F.2d 960, 963 (10th Cir. 1987)("Personal liability for a corporation's debts cannot be imposed on an individual merely because he is an officer or shareholder of that corporation.")

B. *Rules Governing Director Conduct*. Directors have certain duties with respect to the management of a corporation, which are most often defined by rules or statute.

a. In the United States, many states have adopted portions of, or all of the Revised Model Business Corporations Act. State statutes governing corporations usually prescribe how directors should manage corporate business, and may contain express limitations on director liability.

i. Section 8.30 of the Revised Model Business Corporation Act provides general standards for directors. Section 8.30 provides, *inter alia*: (a) A director shall discharge his duties as a director, including his duties as a member of the committee: (1) In good faith; (2) With the care of an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) In a manner he reasonably believes to be in the best interests of the corporation.

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[1] These materials relate to the liability of directors of a corporation, not its officers. In some cases, there is substantial overlap in the circumstances under which an officer may be liable to the corporation. For example, under Delaware law, corporate officers owe fiduciary duties to the corporation that are identical to those owed by corporate directors. *See Gantler v. Stephens*, 965 A.2d 695, 708 (Del. 2009). However, officer conduct and management of a corporation may also be governed by separate statutory requirements (Ex. 8 Del. C. § 142 (discussing duties of corporate officers)), and these materials are limited to a discussion of director liability.

ii. Section 8.30 of the Revised Model Business Corporation Act also provides that a "director is not liable for any action taken as a director, or any failure to take action, if he performed the duties of his office in compliance with this section." *See* § 8.30(d).

b. Corporate documents that may inform director liability include corporate bylaws and articles of incorporation.

C. *Exceptions to General Rule*. Directors may be held personally liable for some or all of the debts of a corporation under certain circumstances.[2]

a. A director consents, or expressly assumes liability such as through a personal guaranty (this would almost always have to be evidenced by a writing).

b. Liability is imposed by statute.

c. Director has breached his or her fiduciary duties.

d. A court disregards the corporate form by "piercing the corporate veil" and holding shareholders and/or directors liable.

i. In assessing whether to "pierce the corporate veil," a court will look to how shareholders and/or directors treated corporate formalities—i.e., was the corporation simply a facade of the controlling shareholder or director? To some extent, the standards by which courts determine whether a corporation's veil should be pierced vary by jurisdiction. For example, in Delaware, courts must find an element of fraud to pierce the corporate veil. *See Winner Acceptance Corp. v. Return on Capital Corp.*, 2008 WL 5352063, at *5 (Del. Ch. Dec. 23, 2008).

II. Directors' Consent to Liability

A. A corporate director may assume personal liability for a corporate debt by an express agreement.

a. *See, e.g., Ruggiero v. FuturaGene, PLC.*, 948 A.2d 1124, 1132 (Ct. Chancery De. 2008)("Delaware law clearly holds that officers of a corporation are not liable on

[2] The circumstances discussed herein do not include situations where a director may be personally liable for the misconduct (criminal or tortious) of a corporation in a circumstance where the director participates in the conduct giving rise to the liability. In that situation, a director may be personally liable for a corporation's wrongful conduct if the claimant can show that: (1) the defendant was a director at the time of the corporation's conduct; (2) the corporation's conduct was wrongful; (3) the corporation's conduct caused damage to the claimant; and (4) the director was responsible for the corporation's conduct. For a full discussion on this kind of cause of action, *see* Mark Cohen & Sierra Swearingen, *Cause of Action to Establish Liability of Corporate Director or Officer for Corporation's Wrongful Conduct*, 36 Causes of Action 2d 441 (Orig. 2008, Updated July 2016).

corporate contracts as long as they do not purport to bind themselves individually"); *Papa John's Int'l, Inc. v. Rezko*, 446 F. Supp. 2d 801, 805-06 (N.D. Ill. 2006)("When a corporate officer makes a personal promise to guarantee his corporation's debts, however, he may be held liable in his personal capacity.")(applying Illinois law).

B. State law governs the enforceability of guaranties and contracts under which a director assumes personal liability for a corporate debt.

a. A personal guaranty generally has to be supported by valuable consideration.

i. *See, e.g., Laborers' Pension Fund v. Dynamic Wrecking & Excavation, Inc.*, 2008 WL 4874110, at * 8 (N.D. Ill. 2008)("A guaranty must be supported by consideration just as in the case for any other contract"); *AXA Inv. Managers UK Ltd. v. Endeavor Capital Mgmt. LLC*, 890 F. Supp. 2d 373, 382 (S.D.N.Y. 2012)("Under New York law...consideration for a guaranty must be expressly or impliedly stated in the instrument[.]"); *Lenbro Holding Inc. v. Falic*, 503 Fed. Appx. 906, 908 (11th Cir. 2013)(applying Florida law and noting that guaranty executed independently of the principal contract must be supported by separate consideration).

b. Courts have found personal guaranties of the debt of corporation to be within the statute of frauds, requiring that the guaranty be in writing. *See Borish v. Graham*, 655 A.2d 831, 834 (Superior Ct. of De. 1994).

III. Directors' Liability for Certain Debts Pursuant to Statute

A. *Liability Imposed by Business Corporation Acts*. Statutes governing corporations vary by state, but legislatures in most, if not all states, have enacted statutes similar to the Revised Model Business Corporation Act that govern corporations. These statutes may have specific provisions prescribing circumstances under which a director may be personally liable for debt of the corporation.

a. Example: Illinois' Business Corporation Act of 1983

i. Directors who vote or assent to any distribution prohibited under the Act are jointly and severally liable to the corporation for the amount of such distribution. 805 ILCS 5/8.65(a)(1).

ii. Directors who carry on the business of the corporation after the filing of articles of dissolution with the Secretary of State can be jointly and severally liable to the creditors of that corporation for debts incurred after such filing in continuing to carry out the business. 805 ILCS 5/8.65(a)(3).

B. *Various State and Federal Statutes that May Impose Liability.* Various state and federal statutes may impose personal liability on directors for the corporation's failure to perform some act, or for the corporation's wrongdoing. An exhaustive list of these statutes, or an analysis of them, goes beyond the scope of these materials.

   a. Example: Texas' Tax Code.

      i. "If the corporate privileges of a corporation are forfeited for the failure to file a report or pay a tax or penalty, each director or officer of the corporation is liable for each debt of the corporation that is created or incurred after the date on which the report, tax or penalty is due[.]" V.T.C.A. Tax Code, § 171.255.

   b. Additionally, even in circumstances where statutes do not expressly name directors as parties who may be held liable for actions or inaction by a corporation, courts may use various canons of statutory interpretation to hold directors personal liable.

      i. Example: *Wadler v. Bio-Rad Laboratories, Inc.*, 141 F. Supp. 3d 1005 (N.D. Cal. 2015)(holding that directors could be individually liable under Sarbanes-Oxley Act as "agents" of corporation.).

IV. Directors' Liability for Breach of Fiduciary Duties

A. *Duties Owed by Directors.* Directors owe fiduciary duties of loyalty and care to the corporation and its shareholders. The duty of loyalty also includes a requirement to act in good faith, which has been described as a "subsidiary element, i.e., a condition, of the fundamental duty of loyalty." *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 115 A.3d 535 (Ct. of Chancery De. 2015).

   a. The duty of loyalty requires that a director act in good faith, in the best interests of the corporation, and refrain from self-dealing or other acts that "would confer an improper personal benefit from a director's relationship with the corporation." *See* Marshall Huebner & Darren Klein, *The Fiduciary Duties of Directors of Troubled Companies*, 34 FEB. AM. BANKR. INST. J. 18 (2015).

   b. The duty of care requires that directors inform themselves of all pertinent material reasonably available to them before making a business decision, and to take action with the requisite degree of care and prudence under the circumstances.

B. *The Business Judgment Rule.* Directors are entitled to a presumption that in making decisions, they acted on an informed basis, in good faith, and with the "belief that the actions taken or decisions made were in the best interest of the corporation." Monique Hayes, *When the Tides Turn: Fiduciary Duties of Directors and Officers of Distressed Companies*, 2015 BUS. L. TODAY 1 (July 2015).

a. Business decisions made by independent directors on an informed basis and with a good faith belief that the decision serves the best interest of the company are protected by the Business Judgment Rule. *Id.*

b. Statutes governing corporations vary by state, but some statutes also expressly allow corporate articles of incorporation to insulate directors from personal liability for breach of fiduciary duty.

i. Example: Delaware's General Corporation Law. In Delaware, a certificate of incorporation may contain a provision "eliminating or limiting the personal liability of a director to the corporation…for monetary damages for breach of fiduciary duty as a director…provided that such provision shall not eliminate the liability of a director" for certain prohibited conduct. 8 Del. C. § 102.

ii. Example: Illinois' Business Corporation Act of 1983. In Illinois, a corporation's articles of incorporation may contain a provision "eliminating or limiting the personal liability of a director to the corporation...for monetary damages for breach of fiduciary duty as a director, provided that the provision does not eliminate or limit the liability of a director" for certain prohibited conduct. 805 ILCS 5/2.10(b)(3).

C. *Business Judgment Rule During Company's Insolvency.* Courts have also noted that "directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation," and to "exercise their business judgment in the best interest of the insolvent corporation." *N. Am. Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007). Thus, directors' informed decisions made while a corporation is insolvent are still entitled to protection by the Business Judgment Rule.

a. After a corporation enters insolvency, directors "continue to owe fiduciary duties to the corporation for the benefit of all residual claimants, a category which now includes creditors." *Quadrant*, 115 A.3d at 546-47. Creditors still cannot bring a direct claim against directors, but they gain standing to assert claims derivatively (i.e., on the corporation's behalf)[3] for breach of fiduciary duty. *Id.*

b. Directors do not have a duty to shut down an insolvent firm and marshal assets for the benefit of creditors.

i. Under Delaware law, directors cannot be held liable for continuing to operate an insolvent entity "in the good faith belief that they may achieve

[3] A derivative action is one that a shareholder may assert on the corporation's behalf against a third party (usually a corporate officer or director) because of the corporation's failure to take some action against the third party. BLACK'S LAW DICTIONARY (10th Ed. 2014).

profitability, even if their decisions ultimately lead to greater losses for creditors." *Quadrant*, 114 A.3d at 547.

ii. Delaware does not recognize a theory of "deepening insolvency." *Trenwick Am. Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 174 (Del. Ch. 2006)("Delaware law does not recognize this catchy term [deepening insolvency] as a cause of action, because catchy though the term may be, it does not express a coherent concept."); *see also Quadrant*, 114 A.3d at 547.

V. Directors' Liability when the Corporate Veil is Pierced

A. *Applicability*. Courts will on occasion disregard the corporate entity, or "pierce the corporate veil," to hold participants in a company personally liable for corporate debts. Commentators have noted that piercing the corporate veil is most commonly applied under circumstances involving closely held companies, and the doctrine is more frequently applied to reach shareholders of a company, rather than officers and directors. F. Hodge O'Neal and Robert M. Thompson, *Personal Liability of Entity Participants*, 2 Close Corp. and LLCs: Law & Practice, § 8:18 (Rev. 3d ed.)(July 2016). However, in closely held corporations, there is more likely to be overlap between the controlling shareholders and directors.

B. *Factors to Consider*. Some factors that a court may consider when assessing a request to pierce the corporate veil include the following:

a. Whether the company was adequately capitalized for the undertaking;

b. Whether the company was solvent;

c. Whether corporate formalities were observed;

d. Whether the dominant shareholder siphoned company funds for personal benefit; and

e. Whether, in general, the company simply functioned as a façade for the dominant shareholder." *Id.*

C. Under Delaware law, courts will only pierce the corporate veil in "exceptional cases." *See, e.g.*, *Sprint Nextel Corp. v. IPCS, Inc.*, 2008 WL 2737409, at *11 (Ct. of Chancery July 14. 2008).

D. Example: In Illinois, courts employ a two-prong test in order to determine whether to pierce the corporate veil: (i) there must be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist; and (ii) circumstances must exist such that adherence to the fiction of a separate corporate

existence would sanction a fraud, promote injustice, or promote inequitable consequences. *See People v. Pintozzi*, 50 Ill.2d 115 (Ill. 1972). *See Fontana v. TLD Builders, Inc.*, 362 Ill. App. 3d 491 (2d Dist. 2005) for an example of a court applying this standard to pierce the corporate veil of a limited liability company to hold its president liable.

Liability of advisors and office-holders in insolvency and restructuring cases

Nick Moser, Taylor Wessing, UK

7 October 2016

Directors' liability relating to pre-insolvency filing period

i) Wrongful trading

- Can only be brought by a liquidator or administrator
- "No reasonable prospect" company would avoid insolvent liquidation or administration
- "Director" includes shadow director
- Director knew or ought to have known – test is objective and subjective
- Company must be worse off because of continuation of trading
- Court can order director to make a contribution to the company's assets, capped at the increase in net deficiency of assets caused by continuing to trade
- Defence – director took every step with a view to minimising potential loss to creditors

Directors' liability relating to pre-insolvency filing period

ii) Fraudulent trading

- Can only be brought by liquidator or administrator
- Person knowingly party to the carrying on of business with intent to defraud creditor(s)
- Not limited to directors (de jure or shadow)
- Liquidator/administrator has to establish dishonesty
- Court can order the person to make a contribution to the company's assets
- Liability only accrues once company is in course of winding up/administration

Directors' liability relating to pre-insolvency filing period

iii) Misfeasance

- Can be brought by liquidator, official receiver or any creditor
- Director has misapplied company funds or committed a breach of duty, e.g. to promote the success of the company
- Once company may be unable to pay debts then the above duty is owed to creditors rather than company
- Court can order repayment, restoration or contribution plus interest
- Director can apply for relief from liability if acted honestly and reasonably, and ought fairly to be excused

Directors' liability relating to pre-insolvency filing period

Range of other challenges that can be brought by administrator or liquidator:

> Transaction at undervalue
> Preference
> Transaction defrauding creditors (which can be brought by creditors)

Directors' liability relating to post-insolvency filing period

- Formal insolvency processes:
  - Liquidation – directors have no continuing liability as executive control passes to liquidator
  - Administration – directors have no continuing liability as executive control passes to administrator

- Debtor-in-possession processes:
  - Scheme of arrangement – directors remain in control
  - Company Voluntary Arrangement (CVA) – directors remain in control

- Until a liquidator or administrator is appointed, directors remain obliged to act in the best interests of all creditors

- While a scheme of arrangement or CVA may strengthen defence to wrongful trading, there remains to duty to take "every step" to minimise losses for creditors and this may require triggering a formal process

Administrator and liquidators' liability to creditors

1. Common law liability for professional negligence:

> Positive duty for administrators/liquidators to exercise reasonable care and skill in the discharge of their duties, e.g.
  - Liquidator:
    - To investigate company's affairs and conduct of officers
    - Realise assets in most efficient way to obtain value for creditors
  - Administrator:
    - Take custody or control of company property
    - Issue proposals to achieve purpose of administration

> A claim for breach of duty can be brought by anyone owed a duty of care

Administrator and liquidators' liability to creditors

2. Misfeasance

> Same elements as directors' liability for misfeasance
> Can be brought by subsequent liquidator/administrator, official receiver or any creditor
> Breach of fiduciary duty e.g. to act in good faith, not to make secret profit, not to act out of self interest or earn unapproved reward
> Court can compel liquidator/administrator to repay or contribute to company's assets i.e. for benefit of all creditors

Administrator and liquidators' liability to creditors

3. Administrators - challenge to conduct:

> Can be brought by a creditor or member of the company
> Where unfair harm to one creditor, or administrator has not acted as quickly or efficiently as reasonably practicable
> Relief generally by court regulating conduct of administration