(2017) 5 NIBLeJ 3

The European Initiative on the Harmonisation of Directors' Duties in the Vicinity of Insolvency

Robbert GOOSENS

Introduction

The European Union (hereafter: EU) has since its foundation a desire to harmonise certain aspects of the company laws of the EU Member States to promote the establishment of a common market.[1] Meanwhile, it is argued that, although business failures affect the proper function of the internal market, company law harmonisation has 'always stopped short' of harmonising insolvency law.[2] Until at least a decade ago, the harmonisation of insolvency law at EU level was considered to be impossible. On 22 November 2016, the European Commission has heralded a new phase in harmonising substantive insolvency law at EU level, by issuing a proposal (hereafter: 'the Proposal') which aims to introduce effective preventive restructuring frameworks, to ensure that honest and indebted entrepreneurs have a second chance and to improve the effectiveness of insolvency proceedings.[3]

Article 18 of the Proposal provides for an obligation for the Member States to impose specific duties upon directors in the vicinity of insolvency. The desire to introduce a harmonised framework in this area can be traced back to 2001 when the High Level Group of Company Law Experts, a body that was set up by the European Commission to make recommendations on a modern regulatory framework in the EU for company law, explored *inter alia* the feasibility of the introduction of a framework rule which would hold company directors accountable for letting the

---

[1] P. Omar, 'The European Initiative on Wrongful Trading' (2003) 6(Nov) Insolvency Lawyer 240.
[2] M. Andenas, 'Insolvency Proceedings in Europe' (1999) 20(8) Company Lawyer 253; Fletcher and Wessels, *Harmonisation of Insolvency Law in Europe: Reports Netherlands Association for Civil Law 2012* (Kluwer 2012) 35.
[3] European Commission, 'Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU' COM(2016) 723 final [hereafter 'the Proposal'].

company continue to do business when it can no longer pay its debts.[4] It emphasized that, although an attempt to harmonise all rules on directors' liability was futile at that stage since they differed significantly from one Member State to another, the harmonisation of specific rules for holding directors liable if the company becomes insolvent was potentially feasible.[5] Ultimately, the High Level Group recommended in its final report to introduce an EU rule on wrongful trading, as the majority of the respondents supported this.[6] Thereafter, following on from the Final Report of the High Level Group, the European Commission issued a communication in which it identified key objectives which should inspire any future action in the area of company law and corporate governance.[7] The key objectives were laid down in an action plan and categorised in short, medium and long term objectives.[8] The development of a wrongful trading rule was identified as a medium term objective (2006-2008).[9] Nonetheless, by 2010, when the Note on Harmonisation of Insolvency Law at EU Level produced by INSOL Europe for the European Parliament (hereafter 'INSOL Report 2010') was published, no developments were made.[10] Unsurprisingly, INSOL Europe drew the same conclusions as the High Level Group of Company Law Experts did eight years before, by pointing out that the laws of the Member States in the EU contained significantly different rules on directors' obligations in the vicinity of insolvency and that this increased forum shopping and reduced good governance.[11] Although the European Parliament also underlined the desirability of harmonising directors' obligations in the vicinity of insolvency on EU level, it did not make any concrete proposals.

Article 18 of the Proposal is an important step towards developing a European framework rule. However, as shall become apparent, the Proposal allows Member States to retain a wide margin of flexibility as to the most appropriate means to implement the standards in their national context. This article shall therefore discuss particular key elements that Member States will have to address in implementing Article 18 of the Proposal; including (1) the nature and extent of the obligations; (2)

---

[4] A Modern Regulatory Framework for Company Law in Europe: A Consultative Document of the High Level Group of Company Law Experts <http://ec.europa.eu/internal_market/company/docs/modern/consult_en.pdf> accessed on 11 November 2017, 15-16.
[5] ibid 15.
[6] Jaap Winter et al, 'Report on Modern Regulatory Framework for Company Law in Europe' (The High Level Group of Company Law Experts, 4 November 2002) <http://www.ecgi.org/publications/documents/report _en.pdf> accessed on 11 November 2017, 12, 68 [hereafter 'Jaap Winter Report 2002'].
[7] European Commission, 'Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward' COM(2003) 284 final 23.
[8] ibid, Annex I.
[9] ibid 25.
[10] INSOL Europe, 'Note: Harmonisation of Insolvency Law at EU level' (European Parliament, 2010) <http://www.europarl.europa.eu/meetdocs/2009_2014/documents/empl/dv/empl_study_insolvencyproceedings_/empl_study_insolvencyproceedings_en.pdf> accessed on 11 November 2017 [hereafter INSOL Report 2010].
[11] INSOL Report 2010, 22.

the moment at which the obligations commence; (3) the definition of a director; (4) statutory defence; (5) the remedies; (6) enforcement.

The Nature and the Extent of the Obligations

The design of directors' obligations in the vicinity of insolvency appears to be a delicate matter on which the various EU Member States take different views.[12] A study on directors' obligations and liability prepared for the European Commission by academics from the London School of Economics shows that all Member States employ one of two main legal strategies to ensure that the creditors' interests are properly protected against wrongful managerial behaviour in the vicinity of insolvency, to wit: either a duty to file for insolvency proceedings or a wrongful trading rule.[13] The filing duty is formulated in a clear and strict way: directors of financially distressed companies are under a legal obligation to file a petition for the opening of formal insolvency proceedings within a specific period of time after the date on which the company becomes insolvent. The wrongful trading rule, on the other hand, provides for an open norm, namely a duty to minimise the potential loss to the company's creditors (i.e. either to rescue the company or to put it into liquidation).

The filing duty is particular common in Napoleonic and Roman-Germanic jurisdictions.[14] The filing duty (in general) envisages to ensure that 'unhealthy' companies which are doomed and can no long sustain themselves independently are liquidated as rapidly as possible.[15] That being said, the opening of formal insolvency proceedings does not automatically result in liquidation, as most jurisdictions provide for various formal insolvency proceedings which potentially result in a preservation of the company or its business. Hence, the filing duty also enables directors to restructure and rescue their financially distressed company. One significant drawback to the filing duty is that directors of healthy companies are discouraged to consider alternative solutions to the company's financial difficulties, such as an out-of-court restructuring procedure, which potentially is a more adequate

---

[12] P. Omar (n 1) 240.

[13] Study on Directors' Obligations and Liability prepared for the European Commission DG Markt by: Casten Gerner-Beuerle, Philip Paech and Edmund Philip Schuster (Department of Law, London School of Economics) London, April 2013, 208-217. Available at <http://ec.europa.eu/internal_market/company/docs/board/2013-study-analysis_en.pdf> accessed on 11 November 2017.

[14] P. Wood, *Principles of International Insolvency* (Sweet & Maxwell 2007) paras 19.026 – 19.036. See for example article 69(2) of the Austrian Insolvency Code, article 7 of the Belgian Bankruptcy Act, article 626-627 of the Bulgarian Commercial Act, article 4(1) in conjunction with article 39(8) of the Croatian Bankruptcy Act, article 98-99 of the Insolvency Act of the Czech Republic, article 306 of the Estonian Commercial Code, article 631-4 and 640-4 of the French Commercial Code, article 15a of the German Insolvency Act, article 586 of the Polish Code of Commercial Companies, article 18-19 of the Portuguese Insolvency Code and article 5 of the Spanish Insolvency Act.

[15] H. Hirte and A. Schall, 'Economic Considerations Regarding the Mandatory Insolvency Petition under German Law' (2010) 22 The Journal of Interdisciplinary Economics 76.

response in order to rescue the financially distressed company.[16] This is unfortunate, as informal workout are normally more flexible, less time-consuming and – perhaps most important – they carry less stigma and therefore result in less reputational damages than formal restructuring proceedings.[17] Admittedly, most legal systems that provide for a filing duty, offer directors theoretically the possibility to contemplate and effectuate an informal rescue within a specified period of time (usually fairly short, such as three weeks).[18] However, the fact that an informal workout must be effectuated within a very short deadline, can seriously impede rescue efforts.[19] After all, directors only benefit from the so-called 'breathing period' if they discover the company's factual insolvency in time. In addition, even if a director has constantly monitored the financial status of the company, the 'breathing period' is normally inadequate as it is an absolute deadline.[20] Thus, even if the director has initiated an informal workout and the prospects of the restructuring efforts are promising, the director is still obliged to file a petition for the opening of formal insolvency proceedings once the deadline is reached. Hence, in reality, directors of financially distressed companies usually take the easiest and safest way out by filing a petition for the opening of formal insolvency proceedings – even if this strategy would not be in the best interest of the creditors. Obviously, this potentially results in the economically undesirable result of forcing directors of viable businesses to file a petition for the opening of formal insolvency proceedings prematurely.[21]

The wrongful trading rule is significantly more flexible than the filing duty, because it allows directors to carry on an out-of-court restructuring procedure as long as a reasonable diligent person would believe that such efforts would minimize the potential loss to the company's creditors. In addition, the wrongful trading rule is stricter than the filing duty, since *any* conduct – both trading and non-trading activities – that aggravates the extent of insolvency, result in a violation of the standard. Notably, any conduct that results in a depletion of the company's assets – such as the payment of generous dividend, condemnable passivity, the sale of any of the company's assets at an undervalue, the payment of excessive salary and the failure to collect debts in due to the company – falls potentially under the scope of

[16] See amongst others R. Parry. *Corporate Rescue* (Sweet & Maxwell 2008) 16, R. Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2010) 31-32, 476-483; J. Garrido, *Out-of-Court Debt Restructuring* (World Bank Publishers 2012) 19-21.
[17] P. Mülbert, 'A Synthetic View of Different Concepts of Credit Protection, or: A High-Level Framework for Corporate Creditor Protection' (2006) 7(1) EBOR 383; Garrido (n 16) 19-21.
[18] E.g. section 15a of the German Insolvency Statute; section 251 (2) of the Companies Act of Croatia.
[19] Hirte and A. Schall (n 15) 76.
[20] M. Schillig, 'The Transition from Corporate Governance to Bankruptcy Governance – Convergence of German and US law? (2010) 7(1) European Company and Financial Law Review 133; Kreft, *Insolvenzordnung – Heidelberger Kommentar* (6th edn, C.F. Müller 2011) 171; Braun and others, *Insolvenzordnung: Kommentar* (15th edn, Beck 2012) 137; Kirchhof, Eidenmüller and Stürner, *Münchener Kommentar zur Insolvenzordnung* (3th edn, Beck München 2013) 415-416; Schmidt and Uhlenbruck, *Die GmbH in Krise Sanierung und Insolvenz* (4th edn, Dr. Otto Schmidt 2016) 972.
[21] Schillig (n 20) 130.

the wrongful trading rule.[22] *Nota bene,* directors can, theoretically, even be held liable if they cease trading prematurely.[23]

Ultimately, the discussion in relation to the use of either a filing duty or a wrongful trading rule boils down to a conflict that arises between two basis economic principles when a company becomes financially distressed, namely: (a) that restructuring is a better alternative than liquidation and (b) that the speedy liquidation of non-viable companies is more preferable than a delayed liquidation.[24] Whereas Member States providing for a wrongful trading rule adhere more strongly to the first principle, Member States providing for a filing duty adhere more strongly to the second.[25]

Taking into consideration the main objective of the Proposal – namely, the reduction of unnecessary liquidation of viable companies – it comes as no surprise that in the eyes of the European Commission, the wrongful trading rule is clearly superior over a filing duty. Article 18 of the Proposal provides that, where there is a likelihood of insolvency, directors have the following obligations: (a) to take immediate steps to minimise the loss for creditors, workers, shareholders and other stakeholders; (b) to have due regard to the interests of creditors and other stakeholders; (c) to take reasonable steps to avoid insolvency; (d) to avoid deliberate or grossly negligent conduct that threatens the viability of the business.

Article 18 of the Proposal does not itself provide for a list of reasonable steps that a director should take in the vicinity of insolvency in order to discharge the duty. Nonetheless, Recital 35 of the Proposal provides for a non-exhaustive list of reasonable steps that directors should take when the company experiences financial difficulties. Appropriate action includes, for example, seeking professional advice and protecting the assets of the company so as to maximize value and avoid loss of key assets. Arguably, it would be preferable if the Member States – in implementing Article 18 of the Proposal – would also provide for a non-exhaustive list so as to provide for more statutory guidance as to what steps directions should take once their company becomes financially distressed.

It is noteworthy that Article 18 of the Proposal sets a less daunting standard than, for example, the English wrongful trading rule which requires directors to take *every step* to minimise the potential loss to the company's creditors. The European Commission consciously opted for a less stringent regime, so as to ensure that

---

[22] D. Prentice, 'Corporate Personality, Limited Liability and the Protection of Creditors' in Charles, Rickett and Grantham, *Corporate Personality in the 20th Century* (Hart Publishing 1998) 118; S. Griffin, *Personal Liability and Disqualification of Company Directors* (Hart Publishing 1999) 64; M. Simmons, 'Wrongful Trading' (2001) 14(2) Insolvency Intelligence 12, 15; Goode (n 16) 667.

[23] A. Hicks, 'Advising on Wrongful Trading: Part 2' (1993) 14(3) Company Lawyer 55; Wood (n 13) para 19.027; Goode (n 16) 667, 674.

[24] Hirte and Schall (n 15) 75.

[25] ibid. 75.

directors are dissuaded from taking reasonable commercial risks.[26] Directors potentially become extremely risk-averse in their decision-making if a strict standard is employed. Directors would potentially be inclined to invest in less risky projects, even though other available (more risky) projects are more lucrative.[27] Obviously this would be in contrast with the general objective of the Proposal to ensure that viable businesses are preserved.

The 'Triggering Event' – the Moment at which the Obligations Commence

The triggering event is an essential element of any framework that imposes obligations upon directors in (the vicinity of) insolvency. There are two main strategies to determine the moment at which the obligations commence. One possibility would be to use a fixed point, namely when the company becomes illiquid (i.e. the company is unable to pay its debts as they fall due) or over-indebted (i.e. the company's assets no longer cover its liabilities). The fact that the 'bright-line' rule makes it, *prima facie,* easy to determine at what moment the duty commences, enhances the transparency and legal certainty.[28] Be that as it may, a 'bright-line' rule arguably does not do much in terms of encouraging directors to respond to the company's financial difficulties at the appropriate point in time.[29] If the obligations commence at a fixed point in time, adequate actions often comes too late since most of the company's value will have been lost by the time that the company is either cash flow or balance sheet insolvent.[30] It has been argued that this is exemplified by the fact that in a substantial amount of insolvency cases in Germany,[31] courts refuse to open formal insolvency proceedings due to an insufficiency of assets to cover the costs of the proceedings.[32]

---

[26] The Proposal recital 36.

[27] R. Daniels, 'Must Boards Go Overboard? An economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance' (1994) 24 Canadian Business Law Journal 249; D. Oesterle, 'Corporate Directors' Personal Liability for "Insolvent Trading" in Australia, "Reckless Trading" in New Zealand and "Wrongful Trading" in England: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders' in I. Ramsay, Company Directors' Liability for Insolvent Trading (CCH Australia Limited and Centre for Corporate Law and Securities Regulation, 2000) 29.

[28] Mülbert (n 16) 402; T. Bersheda, 'Insolvency Act 1986, Section 214: A Model for the European Initiative on Wrongful Trading?' (2005) Cambridge Student Law Review 65.

[29] H. Eidenmüller, 'Trading in Times of Crisis: Formel Insolvency Proceedings, Workouts and the Incentives for Shareholders/Managers' (2006) 7(1) EBOR 250; G. Spindler, 'Trading in the Vicinity of Insolvency (2006) 7(1) EBOR 347.

[30] T. Bachner, 'Wrongful Trading – A New European Model for Creditor Protection?' (2004) 5(2) EBOR 295; Eidenmüller (n 29) 250; Spindler (n 29) 347

[31] In Germany, the duty to file for the opening of formal insolvency proceedings commences at a fixed point in time, namely when the company is either illiquid (*Zahlungsunfähigkeit*) or over-indebted (*Überschuldung)*. See section 15a (1) of the German Insolvency Statute.

[32] Bachner (n 30) 295; A. Schall, 'The UK Limited Company Abroad – How Foreign Creditors are Protected after *Inspire Art* (Including a Comparison of UK and German Creditor Protection Rules)' (2005) 16(6) European Business Law Review 1547. See for recent statistics: https://www.genesis.destatis.de/genesis/online/logon?sequenz=tabelleErgebnis&selectionname=52411-0004&language=en.

Another possibility would be to use a 'flexible' test – giving judges a certain margin of discretion – to determine the moment at which the obligations commence. In the UK, for example, directors should take every step to minimise the potential loss to the company's creditors at 'at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that *there was no reasonable prospect* that the company would avoid going into insolvent liquidation or entering insolvent administration' (emphasis added).[33] In practise, the starting point of wrongful trading liability is determined on the basis of a retrospective analysis of the company's financial state.[34] The English courts usually select a crisis point on the basis of which the director should have concluded that insolvent liquidation or insolvent administration was inevitable.[35] Evident crisis points are a cash-flow crisis,[36] a refusal of a major supplier to make further deliveries[37] or the loss of key employees.[38]

The beauty of a 'flexible' test is that it imposes a duty on directors to respond to a crisis even *before* the company is factually insolvent, therewith incentivising directors to take action at an appropriate moment.[39] In reality, however, this is a rosy-tinted scenario as directors in the UK are normally charged with wrongful trading liability from a relatively late date. Courts are frequently being criticised for being biased.[40] Hindsight bias is a psychological phenomenon on the basis of which an individual believes that an event was more predictable than it actually was.[41] A basic example of hindsight bias in a wrongful trading case is where the court fails to try to understand the (uncertain) position in which the director was acting at the relevant time and to hold the director liable for wrongful trading simply because it believes that the director 'knew all along' that the company would not be able to avoid insolvent liquidation or insolvent administration. The English courts appear to be aware of the dangers of hindsight bias, as they are unwilling to second-guess directors on commercial matters and tend to give them the benefit of the doubt.[42]

---

[33] Section 214 (2)(b) and 246ZB(2)(b) of the British Insolvency Act of 1986.
[34] Griffin (n 22) 65.
[35] See amongst others Griffin (n 22) 65; Cooke and Hicks, 'Wrongful Trading – Predicting Insolvency' (1993) JBL 339; H. Hirt, 'The Wrongful Trading Rule in UK Law: Classification, Application and Practical Significance' (2004) 1(1) ECFR 106.
[36] *Re Purpoint Ltd* [1991] B.C.C. 121. See also C. Cook, 'Wrongful Trading – Is it a Real Threat to Directors or a Paper Tiger?' 1999 3(Apr) Insolvency Lawyer 99-100.
[37] *Re DKG Contractors Ltd* [1990] B.C.C. 903.
[38] Cooke and Hicks (n 35) 339.
[39] Bachner 2004 (n 30) 295; P. Davies, 'Directors' Creditor-Regarding Obligations in Respect of Trading Decisions Taken in the Vicinity of Insolvency' (2006) 7 *EBOR* 317; Spindler (n 29) 349; Gerner-Beuerle and Schuster, 'The Evolving Structure of Directors' Obligations in Europe' (2014) 15(2) EBOR 225.
[40] For example, B. Cheffins, *Company Law: Theory, Structure and Operations* (Clarendon Press 1997) 543.
[41] Roese and Vohs, 'Perspectives on Psychological Science' (2012) 7(5) Perspectives on Psychological Science 411; Simmons (n 22) 13-14.
[42] The Law Commission, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Obligations* (Consultation Paper No 153, 1998) para 15.30; Cooke and Hicks (n 35) 341; A. Keay, 'Wrongful Trading and the Liability of Company Directors: A Theoretical Perspective' (2005) 25(3) Legal Studies 440.

Hence, English courts are reluctant to identify the moment at which wrongful trading commenced too far back from the moment that the company has gone into insolvent liquidation or insolvent administration.[43] In a majority of the reported wrongful trading cases, the English court used a cash flow test to determine whether the director knew or should have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation or insolvent administration.[44]

Some Member States have developed a wrongful trading rule that explains in more detail the moment at which liability commences. For example, liability under the Hungarian wrongful trading rule commences at the moment that the director knew or should have reasonably foreseen that the company would not be able to pay its debts when they fell due.[45] In essence, this means that liability commences at the moment that the director knows or should reasonably foresee that the company becomes cash flow insolvent. The European wrongful trading rule recommended by the High Level Group of Company Law Experts in 2002 provided for a similar test, namely, a director would be held liable for 'letting the company to continue to do business when it should be *foreseen that it will not be able to pay its debts*' (emphasis added).[46] The so called 'imminent insolvency test' provides arguably for more legal certainty than the 'no reasonable prospect test', as it is more easy for directors to foresee whether the company is able to pay its debts when they fall due than to predict whether the company would be able to avoid insolvent liquidation or insolvent administration.[47] Note that the creditor-regarding obligations do not commence under the English wrongful trading rule as long as a reasonable director would believe that the insolvent company would be able to trade out of its financial difficulties (e.g. if the director honestly believes that the company only experienced some temporary cash flow problems (see table 1)). After all, under these circumstances, directors could plead that their actions were defensible on the basis of the honest assumption that a reasonable director would believe that there is a reasonable prospect of avoiding liquidation. In essence, the 'no reasonable prospect test' implies the taking into account of an uncountable series of factors, therewith making it an extremely vague standard.[48] Admittedly, the 'imminent insolvency test' also implies the taking into account of a series of factors and does not provide for a fixed starting point either. Yet, this is inherent to the 'flexible' test. After all, the beauty of the 'flexible' test to determine the 'moment of truth', is that it encourages an early managerial response to the company's financial difficulties.

---

[43] A. Keay, *Company Directors' Responsibilities to Creditors* (Routledge-Cavendish 2007) 129.
[44] *Re Purpoint Ltd* [1991] B.C.C. 121; *Re Rod Gunner Organisation* [2004] B.C.L.C. 110. See also Bachner (n 30) 303; Davies (n 39) 319; Mülbert (n 17) 382-383; Gerner-Beuerle and Schuster (n 39) 226.
[45] See article 33A (1) of the Hungarian Insolvency Act.
[46] Recommendation III.13 of the Jaap Winter Report 2002.
[47] Prentice (n 22) 113; D. Arsalidou, 'The Impact of Section 214(4) of the Insolvency Act 186 on Directors' Obligations (2001) 22(1) Company Lawyer 20; A. Keay, 'Wrongful Trading: Problems and Proposals' (2014) 65(1) Northern Ireland Legal Quarterly 75.
[48] F. Denozza, 'Different Policies for Corporate Creditor Protection' (2006) 7(1) EBOR 414.

	Cash flow crisis foreseeable; no reasonable prospect of avoiding liquidation	**Cash flow crisis foreseeable; reasonable prospect of avoiding liquidation**
Imminent insolvency test	Creditor-regarding obligations commence	Creditor-regarding obligations commence
No reasonable prospect test	Creditor-regarding obligations commence	Creditor-regarding obligations **do not** commence

The biggest drawback of the 'imminent insolvency test' is that viable companies that are facing temporary or minor cash flow problems, are potentially liquidated prematurely.[49] This concern was the main reason for the UK Government to reject the idea of the UK Company Law Review Steering Group to introduce a duty for directors to consider the interests of the company's creditors once there is *a substantial probability of an insolvent liquidation* (i.e. once a failure to meet the company's liabilities is more probable than not).[50] The UK Government emphasised that the fear for personal liability could result in excessive caution and that this was inconsistent with the policy to promote a 'rescue culture'.[51] Admittedly, premature liquidations result in unnecessary social costs. However, it is crucial to emphasise that European wrongful trading rule – as laid down by Article 18 of the Proposal – does not impose a duty on directors to liquidate the company – quite the opposite: it encourages directors to avoid insolvency and to restructure the company if this minimises the loss to the creditors.[52]

In essence, in the search for an adequate triggering event one has to choose between either (a) a thoroughly described formal test that creates – at least as much as possible – legal certainty for the directors , or (b) a vague and debateable *but* 'flexible' test that could trigger the obligations even *before* the company is factually insolent.[53] These two different approaches can be understood as a prime example of the well-known contrast between rules (sub a) versus standards (sub b).[54] The respective advantages and disadvantages of rules and standards are extensively considered elsewhere, and it would go beyond the scope of this thesis to scrutinise them here.

---

[49] Eidenmüller (n 29) 252.
[50] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy – Final Report* (Volume I, URN 01/942, 2001) 44-45. In essence, the Steering Group proposed the codification of the case *West Mercia Safety Wear Ltd v Dodds* [1998] B.C.L.C. 250 CA.
[51] The Secretary of State for Trade and Industry, *Modernising Company Law* (Cmnd 5553-I, 2002) para 3.11.
[52] Eidenmüller (n 29) 252.
[53] Denozza (n 48) 414-415.
[54] Mülbert (n 17) 403; Denozza (n 48) 414.

The EU Commission has clearly given preference to a 'flexible test' Article 18 of the Proposal clearly provides that the obligations commence 'where there is a likelihood of insolvency'. What constitutes a 'likelihood' of insolvency is elusive, as the term is not defined in the Proposal. Nonetheless it is evident that the EU Commission envisages to impose obligations upon directors before the company is factually insolvent as the framework should contribute to the general objective of the Proposal to ensure that viable companies can be *timely* restructured. In light of the transparency and legal certainty, it would be recommendable if the EU would define what is meant by a 'likelihood of insolvency', so as to assure legal uniformity. Arguably, as already observed, the 'imminent insolvency test' could be suitable to determine when there is a likelihood of insolvency in the meaning of Article 18 of the Proposal. Hungary, for example, has employed this approach for over ten years and it appears to be workable and appropriate.[55] The Hungarian courts have explicitly held that the obligations arise if the directors are unable to settle the debts in due time, regardless of whether the company was actual insolvent or not.[56]

The Definition of a Director

What is remarkable is that most Member States do not provide for clear statutory guidance as to who qualifies as a 'director'. It is widely agreed that formally appointed directors (i.e. *de jure* directors) are primary responsible.[57] Nevertheless, many jurisdictions impose at least some obligations upon additional persons who exercise influence over the company. To start with, most States extend at least some of the obligations to individuals who – whilst not being formally and legally appointed – perform the same tasks as a *de jure* director. These individuals normally actively take part in the management of the company and represent the company with the consent of the shareholders (i.e. *de facto* directors). Additionally, some States impose obligations upon so-called shadow directors, that is to say, individuals in accordance with whose directions or instructions the directors of a company are accustomed to act.[58] As opposed to *de facto* directors, shadow directors do not represent the company externally but are said to be the puppet-masters or string-pullers who usually will lurk in the shadows.[59]

---

[55] Liability arises under the Hungarian insolvent trading remedy if the director failed to primarily exercise its powers in the best interest of the creditors *in the event of threatening insolvency* (i.e. when the director knew or should have reasonably foreseen that the company would not be able to pay its debts when they fell due). See Article 33A (1) of the Hungarian Insolvency Act.

[56] T. Braner and P. Nagy, 'Supreme Court Decision in Hungary Interprets the Term "Threatening Insolvency"' (*Taylor Wessing RCR Update,* October 2014) <https://sites-taylor-wessing.vuturevx.com/12/805/landing-pages/rcr-2014-10-supreme.asp> accessed on 1 November 2017.

[57] P. Omar, 'Wrongful Trading: Prospects for a Harmonizing Text in the European Union' (2004) 1(6) ICR 298.

[58] E.g. sections 214 (7) and 246ZB (7) of the British Insolvency Act of 1986 in conjunction with section 251 of the British Companies Act of 2006; section 610 in conjunction with section 611 (6) of the Irish Companies Act of 2014 (CA 2014); section 316 (5) of the Maltese Companies Act.

[59] R. Grogorian, 'Shadow Directors and Wrongful Trading: Shadow Directors' (1997) 15(11) International Banking and Financial Law 126; M. Hobson, 'The Law of Shadow Directorships' (1998) 10(2) Bond Law Review 207; Simmons (n 22) 14.

From a creditor protection perspective, it appears to be preferable to also impose the obligations upon non-appointed individuals who exercise influence over the company so that the real decision-makers do not avoid liability. To illustrate this point, take the example of a parent company that uses its subsidiary to incur new debts in favour of itself at the expense of the subsidiary's creditors. In theory, the parent company is not liable for the subsidiary's debts due to the separate legal entity principle.[60] Nonetheless, by qualifying the parent company as a shadow director, one can pierce the corporate veil that 'protects' the parent company.[61]

Unfortunately, the extension of the obligations upon so-called shadow directors is not without its problems. The main criticism that can be levied against extending liability to shadow directors is that it also creates a problem for creditors, notably banks, as they themselves can potentially be liable as a shadow director of the company. A bank that extends credit to a financially distressed company normally takes extra measures to secure its loan.[62] The loan agreement between the bank and the distressed company usually provides for detailed requirements as to what the company can and cannot do.[63] Some banks oblige companies to implement their recommendations. Thus, the bank normally has a significant influence on the company's decision-making, therewith arguably falling within the statutory definition of a shadow director.[64] This possibility potentially impedes a rescue culture, since the fear of becoming a shadow director might be a disincentive for banks to provide finance to financially distressed companies.[65]

Be that as it may, it has been argued that it undesirable to introduce a statutory exception that excludes all banks from the definition 'shadow director', as it is essential to retain a potential sanction against banks.[66] After all, it has been observed that banks could urge debtor companies to continue to trade, as they normally have an adequate margin of security to protect their interests.[67] As Hicks has argued: '[b]anks want to lend money and not to call it in'.[68] In theory, this could have an adverse impact on the objective to ensure that insolvent companies are are put off the market at the appropriate time.[69] In addition, in practise, banks can relatively easy reduce the risk to be classified as a shadow director, by keeping accurate notes of all relevant meetings that show that the company eventually decided as to whether

[60] Gower and Davies, *Principles of Modern Company Law* (9th edn, Sweet & Maxwell 2012) 178, 202; I. Mevorach, 'Appropriate Treatment of Corporate Groups in Insolvency: A Universal View' (2007) 8(2) EBOR 180.
[61] Prentice (n 22) 115-118; Hirt (n 35) 90.
[62] Prentice (n 22) 114.
[63] P. Fidler, 'Banks as Shadow Directors' (1992) 7(3) Journal of International Banking Law 97.
[64] Fidler (n 63) 97; Simmons (n 22) 14; E. Hadjinestoros, 'Fear of the Dark: Banks as Shadow Directors' (2013) 34(6) Company Lawyer 169.
[65] Hadjinestoros (n 64) 174.
[66] Hicks (n 23) 58-59; Spindler (n 29) 345-346.
[67] Hicks (n 23) 59; Spindler (n 29) 345.
[68] Hicks (n 23) 59.
[69] ibid.

to continue trading or to file a petition for the opening of formal insolvency proceedings.[70]

What immediately strikes the eye is that the Proposal allows Member States to retain a wide margin of discretion as to identify the parties who owe the obligations in the vicinity of insolvency. Recital 36 of the Proposal merely provides: '[d]irectors for the purposes of this Directive should be persons responsible for taking decisions concerning the management of the company.' The European Commission refrained from using terms as '*de facto* directors or 'shadow directors'. That being said, the term 'director' within the meaning of the Proposal evidently is not confined to those who are formally appointed as directors. A person is considered to be a director – regardless whether her or she is formally appointed as a director or not – when he or she is charged with making or does in fact make key decisions concerning the management of the company. Unfortunately, as the Proposal provides for little guidance as to what key functions are typically performed by directors, there is a risk that the term 'director' will split into various fragmented meanings among the EU Member States. In turn this could seriously jeopardize the objective of the Proposal to introduce a level playing field. So as to avoid this unwelcome effect, the European Commission could arguably provide for more clarity as to what key functions are typically performed by directors concerning the management of the company. These key functions could for example be deduced from principles developed by the Organisation for Economic Co-operation and Development (e.g. reviewing and guiding corporate strategy, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures).[71]

Remedies

What is noticeable is that the Proposal does not provide for remedies for directors who fail to comply with their obligations. Put differently, directors face upon initial glance no consequences when they fail to take, for example, immediate steps to minimise the loss for creditors. The Member States retain flexibility as to the most appropriate means to to rectify and/or counteract violations of directors' obligations in (the vicinity of) insolvency. Different remedies and combinations of remedies have been developed by the Member States. Typically, two remedies can be distinguished, namely: civil liability and disqualification.

[70] Fidler (n 63) 100; G. Bhattacharyya, 'Shadow Directors and Wrongful Trading Revisited' (1995) 16(10) Company Lawyer 314.
[71] OECD Principles of Corporate Governance 2004, section VI. The document can be found here: <https://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf> accessed on 11 November 2017.

Civil Liability

Most Member States provide for provisions that envisage to compensate creditors who have suffered loss or damage as a consequence of wrongful managerial behaviour. Be that as it may, the Member States have developed diverging approaches.

Establishing the Quantum of Compensation

To start with, the Member States have developed diverging approaches to calculate the quantum of compensation. Some Member States focus on the position of the company. In the UK, the maximum amount of any contribution normally corresponds to the amount by which the company's assets have been depleted during the period of wrongful trading.[72] In essence, on the basis of the so-called 'increase in net deficiency test' (IND test), the director is liable for the difference between the value of the company's assets (i.e. the total assets and liabilities of the company) at the time the company should have ceased trading and the time it actually did so.[73] Hence, courts only take into consideration the losses incurred by the company.[74]

By contrast, other Member States focus on the position of the creditors. In Germany directors are liable for the difference between the hypothetical dividend that would have been distributed to the creditors at the moment in time when the directors should have filed a petition for the opening of formal insolvency proceedings and the dividend that is actually available to the company's creditors from the insolvent estate (*Quotenschaden*).[75] If the actual amount of dividend is lower than the hypothetical amount of dividend, the director is liable to compensate the difference. The so-called *Quotenschaden* test appears *prima facie* to be similar to the IND-test employed by the English courts under which a director is liable for the difference between the value of the company's assets (i.e. the total assets and liabilities of the company) at the time the company should have ceased trading and the time it actually did so. However, Bachner has shown that, in theory, the *Quotenschaden* test offers more protection to creditors than the IND-test:[76]

> "Let us assume that the company originally holds assets totalling 40 and owes debts totalling 100. Creditors would receive a dividend of 40 per cent of their nominal claims (or 40 pence in the pound, as they would put it in Britain). If the directors now apply assets worth 20 to satisfy one creditor, there remain assets of 20 and debts of 80, so that the dividend for the other creditors drops

[72] *Re Produce Marketing Consortium Ltd (No 2)* [1989] B.C.L.C. 520, 533e; *Re Brian D Pierson (Contractors) Ltd* [1999] B.C.C. 26, 56C.
[73] Prentice (n 22) 122; Bachner (n 30) 311; Davies (n 39) 325.
[74] *Re Continental Assurance* [2001] B.P.I.R. 733, 5. Bachner (n 30) 311.
[75] E.g. BGH 30 March 1988, II ZR 146/69. See also T. Bachner, *Creditor Protection in Private Companies: Anglo-German Perspectives for a European Legal Discourse* (Cambridge University Press 2009) 196; Schillig (n 20) 134; Kreft (n 20) 178; Schmidt and Uhlenbruck (n 20) 977.
[76] Bachner (n 30) 312; Kirchhof, Eidenmüller and Stürner (n 20) 431.

> to 25p in the pound. However, the difference between debts and assets remains the same: 100 minus 40 = 80 minus 20."

Thus, the German filing duty also protects creditors against preferential payments made in the vicinity of insolvency. Hence, from a creditor protection perspective, the *Quotenschaden* test appears preferable. That being said, most Member States provide for transactions avoidance provisions that protect creditors against preferential payments.[77] In turn, this diminishes the significance of the differences between the two approaches.

The Exceptional Position of 'New Creditors'

What is remarkable is that some Member States treat 'old' creditors (i.e. creditors whose claims predate the point at which the director should have filed for insolvency proceedings) differently than 'new' creditors (i.e. creditors who have extended new credit to the company after the point at which the director should have filed for insolvency proceedings). German Courts, for example make a distinction between so-called 'new creditors' (*Neugläubiger*) and 'old creditors' (*Altgläubiger*).[78] Since the leading case of the German Federal Court of Justice of 1994, [79] 'new' creditors are entitled to recover any losses that they have suffered because they entered into a contractual relationship with an insolvent company, that is to say, a company which was under a legal obligation to file a petition for the opening of formal insolvency proceedings (*Vertrauensschaden*). These creditors can, for example, claim any variable costs that they have incurred to manufacture certain products for the insolvent company.[80] In some situations, directors are even obliged to compensate a loss of chance (i.e. where a breach of section 15a of the German Insolvency Act has deprived a new creditor of the opportunity to enter into a (profitable) legal relationship with another company).[81]

The rationale behind a different treatment between 'old' creditors and 'new' creditors is simple. In short, the *Quotenschaden* test is considered to be unfair in order to calculate the quantum of compensation for 'new' creditors. Knowing of the insolvency, the 'new' creditors would either have entered into a transaction with the liquidator (and hence would have benefited from a preferential treatment) or would not have entered into a transaction at all.[82] Their loss is therefore not reflected in the diminution of the quota. To illustrate this point, take the example of a solvent

[77] E.g. section 239 of the British Insolvency Act of 1986; section 133 of the German Insolvency Statute; section 47 of the Dutch Bankruptcy Act.
[78] Bachner (n 75) 196-197; Schillig (n 20) 134-135; Kreft (n 20) 176, 178; Braun and others (n 20) 137; Kirchhof, Eidenmüller and Stürner (n 20) 389; Schmidt and Uhlenbruck (n 20) 974.
[79] BGH 6 June 1994, II ZR 292/91.
[80] Bachner (n 75) 202; Schillig (n 20) 135; Kirchhof, Eidenmüller and Stürner (n 20) 437; Schmidt and Uhlenbruck (n 20) 978.
[81] Soó (n 460) 179; Bachner (n 75) 202; Kirchhof, Eidenmüller and Stürner (n 20) 435.
[82] Bachner (n 30) 316; Schall (n 32) 1542; Z. Soó, 'Die Insolvenzantragspflichten des Vorstands in dem Deutschen Recht' (2009) 5 Lustum Aequum Salutare 178.

German limited liability company entering into a contractual relationship with creditor A. Assume that at moment X, the company becomes over-indebted, because it holds assets totalling 40 and owes debts totalling 100. Thereupon, the company descends further into factual insolvency. At moment Y, creditor B also enters into a transaction with the insolvent company which – at that moment – holds assets totalling 40 and owes debts totalling 200. Ultimately, by the time that the company holds assets totalling 40 and owes debts totalling 400, the director files for the opening of formal insolvency proceedings (moment Z). Whereas the loss of creditor A (i.e. an 'old' creditor) on a € 100 claim would be € 30 (i.e. the difference between the hypothetical dividend at moment X (€ 40) and the lower actual dividend payable at moment Z € 10)), the loss of creditor B (i.e. a 'new' creditor) on a € 100 claim would be € 90.[83]

<u>Discretion of the Courts</u>

Some Member States permit their Courts to adjust the quantum of compensation to match the nature and seriousness of the wrongful managerial behaviour. In the UK, the quantum of compensation is left entirely to the discretion of the courts.[84] The British courts have settled that the diminution of the company's assets as a result of the wrongful behaviour is the *maximum* quantum of liability.[85] The quantum of compensation can be reduces by taking into account other factors, such as the degree of involvement in the managerial decision making process, the lack of a causal link,[86] the degree of business experience and the degree of culpability.[87]

By contrast, the statutory discretion conferred upon German courts is very limited. Pursuant to § 287 of the German Code of Civil Procedure, German courts may only determine the quantum of compensation on a discretionary basis if it is unclear whether or not damages have occurred and/or the amount of damages is unclear. Thus, as opposed to English courts, German courts are *not* entitled to adjust the extent of liability by taking into account other factors (e.g. the degree of involvement in the managerial decision making process).[88]

The beauty of a wide discretion for the court is that this reduces the chilling effect of the framework rule, therewith potentially reducing premature liquidations and

[83] Schall (n 32) 1542.
[84] Pursuant to sections 214 (1) and 246ZB of the British Insolvency Act of 1986, the court may declare that any director who has been held liable for wrongful trading is obliged to make 'such contribution (if any) to the company's assets *as the court thinks proper*' (emphasis added). See amongst others Griffin (n 22) 83; Hirt (n 35) 100; Bachner (n 30) 310; R. Werdnik, 'Wrongful Trading Provision – is it Efficient?' (2012) 25(6) Insolvency Intelligence 86.
[85] Griffin (n 22) 83-84; Bachner (n 30) 313-314; Werdnik (n 84) 86.
[86] In theory, it is not necessary to establish a causal link between wrongful trading and any loss arising from it. Nonetheless, when the loss is not caused by the director who has been held liable for wrongful trading, the court can adjust the amount of compensation. See *Re Continental Assurance* [2001] B.P.I.R. 733, 377-380; *Re Robin Hood Centre plc (in liquidation)* [2015] EWHC 2289 (Ch) 287d.
[87] *Re Brian D Pierson (Contractors) Ltd* [1999] B.C.C. 26, 57C. See also Simmons (n 22) 14.
[88] Bachner (n 30) 315.

promoting a rescue culture.[89] The main criticism that can be levied against a wide discretion for the court is that this reduces the amount of compensation for the creditors, therewith decreasing the effectiveness of the wrongful trading rule to curb detrimental opportunistic behaviour by directors in the vicinity of insolvency.[90]

With an eye towards introducing a level playing field and enhancing legal certainty, it would be preferable if Member States would adopt a similar approach with regard to the level of discretion to establish the quantum of compensation. Unfortunately, it has been debated that, in reality, this is highly unlikely as there is a clear difference in how judges view their roles. Whereas German Courts are inclined to apply the law in a rule-bound manner, British courts are more willing to take into account peculiar factors to adjust the quantum of compensation wherever possible.[91] The European Legislator is faced here with a striking example of the limits of maximum harmonisation, due to the significant differences between the various legal cultures of the EU Member States.

Disqualification Procedure

Research has shown that nearly all Member States provide for some form of disqualification regime.[92] Such measures are typically designed to remove unfit directors from a position where they can cause more damage by continuing to manage a company irresponsibly.[93] In addition by disqualifying directors, the public is reassured that the companies are managed by directors who are obliged to adhere to a minimum standard of conduct, therewith enhancing commercial morality and confidence in the market.[94]

As one would expect, the various disqualification procedures vary significantly. First of all, in most Member States the disqualification regime depends on criminal proceedings. In Germany, for example directors shall only be disqualified if they have been convicted for committing the *criminal offence* of violating the filing duty.[95] One very serious drawback of having a regime that depends on criminal proceedings is that the burden of proof is very demanding, therewith making it more

[89] Davies (n 39) 325.
[90] Bachner (n 30) 318; Eidenmüller (n 29) 253.
[91] Bachner (n 30) 316.
[92] McCormack, Keay, Brown, and Dahlgreen, 'Study on a New Approach to Business Failure and Insolvency: Comparative Legal Analysis of the Member States' Relevant Provisions and Practices' available at <http://ec.europa.eu/justice/civil/files/insolvency/insolvency_ study_2016 _final_en.pdf> accessed on 11 November 2017, 65-68.
[93] A. Keay 'The Duty of Directors to Take Account of Creditors' Interests: Has it any Role to Play?' (2002) JBL 389.
[94] R. Schulte, 'Enforcing Wrongful Trading as a Standard of Conduct for Directors and a Remedy for Creditors: The Special Case of Corporate Insolvency' (1999) 20(3) Company Lawyer 80; Keay (n 47) 79.
[95] Section 6(2)(III)(a) of the German Limited Liability Companies Act and Section 76(3)(III)(a) of the German Stock Corporation Act.

difficult to disqualify a director.[96] By contrast, in some Member States the disqualification regime depends on civil liability (which requires a less demanding burden of proof).[97] In the UK, section 10 of the Company Directors Disqualification Act 1986 (CDDA) empowers the court to make a disqualification order against any director who has been held liable for wrongful trading. Notably, from a creditor protection perspective, the British approach appears to be more preferable, and indeed, some Member States are recently contemplating the introduction of a civil law disqualification instrument.[98]

Another distinctive difference between the various disqualification regimes within the EU is the period for which directors can be be disqualified. Whereas some Member States provide for a range (e.g. 2-15 years in the UK and Spain) and leave it to the discretion of the court to decide the exact length of the disqualification period, other Member States provides for a fixed disqualification period (e.g. 5 years in Germany and Hungary).

That being said, there are some difficulties with regard to the extraterritorial effect of disqualification orders. First of all, there is some ambiguity as to whether there is an obligation upon Member States to automatically recognise foreign disqualification orders with no further formalities.[99] Whereas in the UK, the Secretary of State may make provisions disqualifying persons subject to foreign restrictions from being a director of a company in the UK,[100] in Germany, foreign disqualification orders merely apply if the director has committed offences which are equivalent to those which would result in a disqualification order under the German Criminal Code.[101] Secondly, even if there is a legal basis for Member States to recognise foreign disqualifications orders, there is little done in those Member States to apply them within their own jurisdiction. In 2016, Gerard McCormack, Andrew Keay, Sarah Brown and Judith Dahlgreen carried out a comprehensive comparative legal study on substantive insolvency laws in all Member States, which pointed out that most Member States do not apply foreign disqualifications within their own jurisdiction as there are few or no inquiries whether an individual who would like to be appointed as a director in one Member States is disqualified in

[96] T. Reker, 'Unqualified Directors in Insolvency: A Comparative Study on the Desirability of Civil Law Directors' Disqualification in the Netherlands' (2014) 23(2) IIR 153-154; McCormack, Keay, Brown, and Dahlgreen (n 92) 69.

[97] Section 10 of the British Company Directors Disqualification Act of 1986.

[98] E.g. the Dutch Government has recently introduced a proposal to introduce a civil disqualification instrument. See Reker (n 96) 145-153.

[99] Article 32 of the Recast Regulation provides that judgments handed down by a court whose judgment concerning the opening of proceedings is recognised in accordance with Article 19 and which concern the course and closure of insolvency proceedings, and compositions approved by that court, shall also be recognised with no further formalities. However, it is often unclear whether disqualification orders qualify as actions which are directly derived from insolvency proceedings and are closely linked with them, since the rules governing such orders are often not clearly seen as either falling within the domain of company law or insolvency law. See in this regard McCormack, Keay, Brown and Dahlgreen (n 92) 75.

[100] Section 1184 of the Companies Act of 2006.

[101] McCormack, Keay, Brown and Dahlgreen (n 92) 71, 75.

another.[102] Consequently, directors who have been disqualified in Member State A are able to perform theirs functions as directors in any other company that is incorporated in another Member State.

It goes without saying that this is an undesirable result. Nonetheless, this issue could relatively easy be overcome by amending Article 24 of the recast European Regulation on Insolvency Proceedings (hereafter: the Recast Regulation).[103] Article 24 (1) of the Recast Regulation provides that Member States shall establish and maintain in their territory one or several registers in which information concerning insolvency proceedings is published ('insolvency registers'). These insolvency registers are interconnected by the so-called European e-Justice Portal, which serves as a central public electronic access point to information laid down in the national insolvency registers that all Member States must establish and maintain.[104] Currently, Member States are *permitted* to include information regarding disqualifications in their national insolvency registers, but they are *not obliged* to do so.[105] If any disqualifications were qualified as 'mandatory information' within the meaning of article 24 (2) of the Recast Regulation, any disqualification orders would be publicly available throughout the EU.

Enforcement

The Proposal also does not provide who may bring an action against a director who breaches the obligations. This is curious, as the efficacy of enforcement predominantly determines the effectiveness of a creditor protection mechanism. Some Member States provide that the insolvency practitioners are the only individuals who are entitled to initiate proceedings. Upon initial glance this is remarkable, as an important justification for imposing obligations upon directors in the vicinity of insolvency is to protect the creditors' interests.[106] Nonetheless, some

---

[102] ibid.
[103] McCormack, Keay, Brown and Dahlgreen (n 92) 72.
[104] Article 24 in conjunction with article 25 of the Recast Regulation.
[105] Article 24 (3) of the Recast Regulation.
[106] Directors who are also shareholders (shareholder-directors) face a strong temptation to behave opportunistically once the company enters into the vicinity of insolvency, as to benefit themselves at the expense of the creditors. Once the company's financial situation deteriorates, shareholder-directors have everything to gain if the risky business strategy succeeds (i.e. they regain at least some of the value of their shares and potentially receive future dividend payments) and very little or nothing to lose if the strategy fails. After all, due to the principle of limited liability, the shareholder-directors suffer no additional losses than their initial capital contributions which are most likely evaporated or significantly reduced at that stage. *Vice versa*, creditors have very little or nothing to gain if the risky business strategy succeeds – as their claims against the company are fixed – but a lot to lose if the strategy fails. Put differently, limited liability creates a 'perverse incentive' for shareholder-directors to behave opportunistically and to continue to trade once the company enters into the vicinity of insolvency no matter how small the chances of success, since all the risks and costs of their behaviour are borne by the creditors. In particular, the unsecured creditors are usually the 'victims' of excessive risk-taking, since they stand next in line, after the company's shareholders, to bear the losses and to become the residual

Member States have consciously limited the scope of potential claimants. To start with, there is an evident risk that individual creditors would exert improper pressure on companies to pay their debts.[107] In turn, this could seriously disturb the stability of an already vulnerably company, therewith potentially increasing the number of premature liquidations.[108] In addition, attributing *locus standi* to creditors would have an adverse impact on the administration of the estate, since the multiplicity of proceedings could seriously jeopardize the principle of *par condicio creditorium* (i.e. *pari passu* treatment of creditors).[109] After all, where strong and well-informed creditors would succeed in proceedings, other creditors would remain empty handed since the director – as a result of the contribution order in favour of the strong and well-informed creditors – would have become impecunious.[110]

A major difficulty that arises in those jurisdiction that solely allow insolvency practitioners to initiate wrongful trading proceedings relates to the treatment of the liquidator's costs in investigating and pursuing such claims.[111] In the UK, for example, an insolvency practitioner is in theory not liable to pay for the litigation expenses out of its own pockets, since any expenses incurred by an insolvency practitioner in the preparation or conduct of a wrongful trading proceeding shall be paid out of the company's estate before any other claims.[112] The insolvency practitioner's expenses are even covered if the wrongful trading claim is unsuccessful.[113] However, there is an evident risk that there are insufficient assets available in the insolvency estate to meet the litigation expenses. In these cases, insolvency practitioners are normally reluctant to initiate wrongful trading proceedings because the risks of having to pay the litigation expenses out of their own pockets is too great.[114] After all, if an insolvency practitioner believes that there is a very good chance of success and initiates wrongful trading proceedings, but the claim is ultimately unsuccessful, he or she ends up bearing a significant proportion or all of the litigation expenses personally.[115] Additionally, even in cases where the court holds a directors liable for wrongful trading, an insolvency practitioner may still end up bearing a large portion or all of the litigation expenses personally if the director disappears or becomes personally insolvent as a result of the corporate

claimants. See in this regard amongst others: D. Prentice, 'Creditor Interests and Director's Obligations' (1990) 10(2) Oxford Journal of Legal Studies 265; Prentice (n 22) 105; Hirt (n 35) 75; Davies (n 39) 306-307; Armour, Hertig and Kanda, 'Transactions with Creditors' in Reinier H Kraakman and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, OUP 2009) 116-117.

[107] Hicks (n 23) 59.

[108] Griffin (n 22) 78.

[109] Bachner (n 75) 204-205.

[110] Keay (n 43) 128.

[111] P. Fidler, 'Wrongful trading after Continental Assurance' (2001) 17 Insolvency Law & Practice 212; Hirt (n 35) 207.

[112] Rule 4.218 (1) of the British Insolvency Rules of 1986; section 176ZA of the British Insolvency Act of 1986.

[113] Werdnik (n 84) 83.

[114] Schulte (n 94) 81; Arsalidou (n 47) 20-21; Davies (n 39) 326; F. Didcote, 'Controlling the Abuse of Limited Liability: The Effectiveness of the Wrongful Trading provision' (2008) 19(12) ICR 374.

[115] Hirt (n 35) 108.

failure.[116] The UK Legislator has tried to overcome this issue by empowering insolvency practitioners to assign a right of action for wrongful trading in exchange for a share in the proceeds.[117] However it is debatable whether this amendment significantly increases the number of additional cases.[118] The main reason for this pessimistic view appears to be the existence of a discrepancy between supply and demand in wrongful trading claims. Whereas third parties prefer to *purchase high-value claims* (i.e. cases where there is a very good chance of success and where the director has sufficient assets to satisfy the contribution order declared under section 214 or 246ZB IA 1986), insolvency practitioners are only likely to *sell speculative claims*, as the high-value claims shall be pursued by themselves.[119]

The funding problem could be overcome if additional individuals or entities are given permission to pursue directors. Some Member States have indeed given creditors *locus standi*. The German Federal Court of Justice, for example, has developed two exceptions that do permit creditors to bring an action. First, every individual creditor is entitled to initiate proceedings if the opening of formal insolvency proceedings is denied as a result of an insufficiency of assets to cover the procedural costs.[120] The rationale behind this exceptions is allegedly that in relation to asset-starved insolvencies the *pari passu* principle is less relevant as it is highly unlikely that any assets shall be realised.[121] Second, 'new creditors' (i.e. creditors who have extended new credit to the company after the point at which the company should have ceased trading) have *locus standi* and must pursue directors individually.[122] The German Federal Court of Justice was of the opinion that it would be impracticable if liquidators would be entitled to recover any compensation for the benefit of 'new' creditors, since the quantum of compensation has to be calculated for each creditor individually.[123] Interestingly, in practice, the enforcement of the German filing duty predominantly rests with the 'new creditors', as German insolvency practitioners face the same funding difficulties (and litigation risks) as the insolvency practitioners in the UK.[124] The fact that the German filing duty can be enforced by new creditors enhances its effectiveness. However, this result comes

[116] Keay (n 47) 71.

[117] Section 246ZD (2)(a) of the British Insolvency Act of 1986.

[118] The Insolvency Service, 'Enabling Liquidators and Administrators to assign to third parties certain rights of action that only they can bring under the Insolvency Act 1986 and to extend the right to bring fraudulent and wrongful trading actions to an administrator' (Impact Assessment IA No: BIS INSS007, 16 April 2014) <http://www.parliament.uk/documents/impact-assessments/IA14-14M.pdf> accessed on 11 November 2017, 8.

[119] R. Williams, 'What Can We Expect to Gain from Reforming the Insolvent Trading Remedy?' (2015) 78(1) MLR 68.

[120] See section 26 of the German Insolvency Act: 'The insolvency court shall refuse a request to open insolvency proceedings if the debtor's assets will probably be insufficient to cover the costs of the proceedings. Such refusal shall be excluded if a sufficient amount of money is advanced, or the costs have been deferred in accordance with section 4a. The order shall be published without delay.' See also Schillig (n 20) 135.

[121] Bachner (n 75) 205.

[122] BGH 6 June 1994, II ZR 292/91.

[123] Bachner (n 75) 201; Schmidt and Uhlenbruck (n 20) 983.

[124] Schillig (n 20) 137.

at the expense of the *pari passu* treatment of creditors.[125] After all, as already mentioned, whereas well-informed creditors who would be quick enough to put themselves in front of the queue would be compensated for (a part of) their losses, other (less-informed) creditors would remain empty handed.

Some Member States that allow creditor action mitigate the risk of jeopardizing the *pari passu* treatment of creditors by establishing that any contribution payments must be made to the insolvency estate in order to assure that any compensation is recovered for the benefit of all, rather than individual, creditors.[126] One significant drawback to this approach is that in reality, creditors are simply not willing to take on considerable risks as any sums recovered are distributed among *all* creditors and do no solely benefit the contributories. A significant free-rider problem exists where creditors do not pursue directors in the hope of benefiting from other creditors' actions.[127] In Ireland, for example, creditors are entitled to initiate reckless trading proceedings, but it seems that few creditors in practise do so.[128]

The divergence in the approaches developed by the various Member States essentially boils down to conflict that arises between two basic principles, namely that an effective creditor protection mechanism should (a) be adequately enforceable, and (b) ensure an equitable treatment of creditors. Whereas Member States such as Germany adhere more strongly to the first principle by allowing (under certain conditions) creditors to initiate proceedings, Member States such as the UK adhere more strongly to the second principle by vesting the insolvency practitioners with the exclusive right to initiate proceedings.

Interestingly, some Member States have developed standards that strike arguably a more optimal balance between the two conflicting principles. Hungary, for example, employs a two-stage procedure.[129] During the liquidation proceedings, creditors can only request the court to make a declaratory judgement establishing that the director failed to primarily exercise its powers in the best interest of the creditors in the event of threatening insolvency (stage I). Once the insolvency proceedings have been concluded, creditors with *unsatisfied* claims have 90 days to apply to the court for an order requiring the directors to satisfy their claims (stage II). As another interesting example, Working Group V of UNCITRAL recommends States to allow creditors to commence proceedings with the agreement of either the insolvency practitioners or the court (if the insolvency practitioners do not agree).[130] The Working Group has therewith developed an approach that could mitigate the risks that creditors are left empty-handed if the insolvency practitioner declines to initiate

---

[125] Bachner (n 75) 204.
[126] Section 214 (1) and 246ZB (1) of the Insolvency Act of 1986. See also Prentice 1998 (n 22) 121-122; Griffin (n 22) 81-82; Hirt (n 35) 101; Werdnik (n 84) 84.
[127] Keay (n 43) 127-128.
[128] ibid 126.
[129] Section 33A (6) of the Hungarian Insolvency Act.
[130] Recommendation 263 of the UNCITRAL Legislative Guide on Insolvency, Part four: Directors' Obligations in the Period Approaching Insolvency.

proceedings while simultaneously preventing a multiplicity of proceedings that could seriously jeopardize the principle of *par condicio creditorium.* If, for example, the insolvency practitioner would be hesitant to initiate proceedings because there are insufficient assets available in the insolvency estate to meet the litigation expenses and/or he or she has difficulties to obtain funding from third parties, he or she could permit creditors to initiate proceedings individually.

Concluding Remarks

With the introduction of Article 18 of the Proposal, a long-cherished whish of the European Legislator has been fulfilled to provide for minimum standards that govern directors' behaviour in the vicinity of insolvency. In itself, this is a major achievement since there are significant differences in the types of legal strategies that EU Member States employ to ensure that the interests of creditors and other stakeholders are properly protected against wrongful managerial behaviour in the vicinity of insolvency. That being said, it is striking that the Proposal only provides for a set of detailed targeted rules with respect to the steps directors should where the company experiences financial difficulties. In relation to the other key elements of a framework imposing obligations upon directors in the vicinity of insolvency, ambiguities still exist as the Proposal allows Member States to retain a wide margin of flexibility in implementing Article 18. To start with, there is no clear statutory guidance as to when the obligations commence, as the triggering mechanism (i.e. 'where there is a likelihood of insolvency') is not defined in the Proposal. There may also be doubts as to the entities to whom the obligations would attach, as the Proposal provides for a relatively vague definition of what constitutes a director. What is also obvious is that there is uncertainty as to the consequences for directors who fail to comply with their obligations as Article 18 of the Proposal does not provide for a single remedy nor does it specify who may bring an action.

As a result, there is a significant risk that – even after the implementation of the Directive – significant differences between the national laws in relation to directors' obligations in the vicinity of insolvency continue to exist. In turn this could stand in the way of the introduction of a level playing field, that is to say, a coherent framework within the EU. After all, this article has shown that the Member States have – due to, *inter alia,* differences in legal culture – developed different approaches to protect creditors and other stakeholders against wrongful managerial behaviour in the vicinity of insolvency. From an ideological point of view, it would be desirable if the Proposal would be amended by providing for more minimum standards in relation to particular essential elements such as the triggering mechanism, the parties who owe the obligations and the potential remedies. In reality, however, this scenario will be unlikely as practice shows that it is extremely difficult to find consensus on the content of such rules.

That being said, Article 18 of the Proposal paves the way towards the introduction of a level playing field, therewith assuring that all directors within the EU must abide by the same set of rules in the vicinity of insolvency. In addition, Article 18 of the Proposal obliges EU Member States to review their insolvency regimes and challenges them to innovate by drawing inspiration from initiatives and developments in other insolvency regimes.