Directors' duties

Dealing with the minefield in a cross-border restructuring

Dominic McCahill and Sally Willcock set out the applicable common law and insolvency rules that impact on directors' duties in England and Wales, Germany, France and the United States, and outline some practical steps that can be taken by directors of struggling companies with cross-border structures to minimise personal liability risks.

One of the key challenges for legal advisers of companies in financial difficulties is how to deal with issues concerning directors' duties and related potential liabilities. Directors, while wishing to ensure that they act in the best interests of the companies they represent, will naturally also be concerned that they are not exposing themselves personally to civil or criminal liability.

Where a group has a cross-border structure, additional complications and issues can arise, depending on where the rele-
Restructuring: directors’ duties

If companies are cross-border and are in financial difficulties, they may need to operate, as this has a key bearing on which law governs directors’ duties and on its interplay with applicable insolvency law.

Against this background, this article:

- Highlights some of the general issues that may need to be considered by legal advisers of struggling cross-border groups.
- Looks at the applicable common law and insolvency rules that impact on directors’ duties in England and Wales, Germany, France and the United States respectively. Particular consideration is given to the likely impact of recent and proposed legislative changes in those jurisdictions.
- Briefly considers the process by which a company can be “migrated” from one jurisdiction to another and as a result subject to a change in the applicable laws, as this strategy has been used in a number of recent complex restructurings (see box, Migration of companies).
- Outlines practical steps that can be taken by directors of struggling companies with cross-border structures to minimise the risk of personal liability (see box, Practical tips: minimising the risk of director liability).

General issues

Legal advisers of cross-border groups that are in financial difficulties may need to consider the following general issues:

- Which law applies to directors’ general corporate duties.
- The interplay between corporate law and insolvency law.
- Establishing the applicable insolvency law.
- Potential civil and criminal penalties.
- Valuation issues and the difficulties in determining the point of insolvency.
- Migration of companies.

Law applicable to directors’ general corporate duties

The first issue likely to arise where there are cross-border structures is identifying the proper applicable law or laws. Under English law principles, for example, questions of directors’ duties are matters of corporate governance that are decided according to the law of the country in which a company is incorporated. Such a law should be readily identifiable. Where a company is carrying on business in a different place to the jurisdiction in which it is incorporated, directors need to be aware of the local corporate law and consider whether this (also) applies. For example, companies carrying on business in Germany, but using the English “Ltd” form, (of which there have been many examples in recent years) are subject to English law rules as regards directors’ general corporate law duties.

In a group with significant cross-border structures, the likelihood is that corporate laws from a number of countries will have to be considered. Even within Europe, only very limited harmonisation of company laws has taken effect or been proposed and there is no simple solution available to allow a consolidated approach to the duties of directors within a corporate group.

The interplay between corporate law and insolvency law

Where a business is edging into financial difficulty, matters can be further complicated, as there can be an overlap with (and where laws from different jurisdictions apply, tensions between) the usual corporate governance laws and the applicable additional insolvency laws. In England, for example, where a company goes into insolvent liquidation, the statutory wrongful trading provisions (section 214, Insolvency Act 1986 [IA 1986]) can come into play and be relied on by a liquidator (see below, England and Wales: IA 1986 and other statutory provisions). A liquidator also has power to bring claims against directors for breach of duty and misfeasance and in this way can swell asset recoveries for the benefit of creditors. Directors therefore need to be aware of the types of action that could be open to them and the types of claims that could be pursued against them under the applicable insolvency law.

They also need to be aware of when a jurisdiction’s insolvency law becomes relevant and starts to apply. Unfortunately, the point at which insolvency laws are triggered and might be used to assert claims against directors can itself be an issue.

Establishing the applicable insolvency law

Different jurisdictions have their own criteria for determining when their insolvency laws apply.

Within Europe, for example, “main insolvency proceedings” can be opened according to the criteria provided under the insolvency laws in place in the jurisdiction in which the company has its “centre of main interests” (COMI). This may or may not coincide with the place where the company was incorporated. The rules for the allocation of jurisdiction and choice of law are set out in Regulation (EC) No 1346/2000 on insolvency proceedings (Insolvency Regulation). Where companies have an “establishment” in another EC jurisdiction (broadly equating to a branch office), “secondary insolvency proceedings” can also be started in the jurisdiction of the establishment. However, secondary proceedings are limited to those types of proceedings that are listed as winding up proceedings (rather than as species of rescue proceedings) in annexes to the Insolvency Regulation.

The US adopts a much broader and permissive approach to the filing of insolvency proceedings so that plenary bankruptcy proceedings under US chapter 11 may be commenced where a debtor resides or has a domicile, a place of business or property in the United States.

The applicable insolvency laws may place constraints on directors’ actions. In addition, the insolvency laws may not be wholly consistent with the corporate laws that govern the company, particularly where the applicable corporate and insolvency provisions are those of different jurisdictions. It follows that directors need to be aware of their obligations in all relevant jurisdictions and take appropriate advice accordingly.

Directors also need to be aware of the risk of insolvency proceedings being started
by creditors, or by directors of other group companies, where this third party action might create difficulties in following through a proposed rescue strategy. Clearly, an informal workout negotiated in one jurisdiction, and covering the whole of a group’s operations, may be blocked in whole or in part where local directors in another jurisdiction are compelled to initiate formal insolvency proceedings locally, to guard against personal liability under local laws. The opening of local formal proceedings often shifts control of the entity to an insolvency office holder and may, for example, prevent any proposed sale of the local enterprise on a going concern basis as part of a group-wide restructuring strategy.

### Potential civil and criminal penalties

In many jurisdictions, where a company is insolvent, positive duties are imposed on its directors requiring them to initiate insolvency proceedings, in some cases within a fixed and short timeframe from the onset of insolvency. Directors may face potential criminal, as well as civil, penalties and possible disqualification if they fail to abide by these rules. Examples of jurisdictions with these provisions include France and Germany (see below).

### Valuation issues and the difficulties in determining the point of insolvency

The issue of whether a company is insolvent, and if so on what basis, can also be unclear in many cases. The tests for insolvency in most jurisdictions are based on variations of either or both of the “cash-flow” and “balance sheet” tests. Applying the balance sheet test can be problematic where there is disagreement as to the correct valuation basis for the entity’s assets. As for the cash-flow test, there are differences in the way this is applied depending on the jurisdiction, with some jurisdictions excluding or excusing occasional variations. Keeping on top of the company’s financial position can add to the pressures on management at a time of financial crisis, but it is important for the directors to keep the company’s solvency under constant review and to obtain expert advice on its status to minimise their potential personal liability.

### Migration of companies

The above factors can lead to friction between management and other stakeholders involved in a proposed restructuring and can hinder the formation and implementation of a restructuring plan, particularly where a cross-border group solution and rescue is proposed. Given these potential difficulties, and other factors, in some recent cases cross-border restructurings have been put together involving the migration of companies from one jurisdiction to a second jurisdiction, where this has been perceived to offer greater scope to achieve a restructuring. Any such proposed migration requires careful planning and advice to directors and also depends on creditor and shareholder consent. (See also box, Migration of companies.)

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**Migration of companies**

There have been a handful of cases in Europe in which a restructuring has been put in place using a process in which the centre of main interests (COMI) of the relevant part of the corporate group is moved from one jurisdiction to another jurisdiction. This process has become known as “migrating” a company.

A migration strategy is reasonably sophisticated, and unless carefully planned and agreed by key creditors there is a significant risk that the strategy may backfire (as was the case in the attempted restructuring of the Hans Brochier group). Migration is unlikely to be a realistic option except in a minority of large-scale restructurings. In those cases where it is proposed, it is likely to be masterminded by a chief restructuring officer appointed to the board of directors to steer the company and its directors through the process.

The first widely reported instance of a migrating corporate COMI occurred in the restructuring of a German coin manufacturer, Deutsche Nickel AG (DNAG), which ran into trading difficulties in 2004. DNAG was the operating subsidiary of the Deutsche Nickel Group, incorporated in Germany as a private company. It had accumulated bank debt of around EUR120 million (about US$170 million) and a similar level of bond debt, and it was proposed to achieve a restructuring by means of a debt for equity swap.

Before the restructuring, DNAG’s COMI was in Germany. However, swapping the bonds into equity out-of-court would, under German law, have required each bondholder’s consent, while an in-court process (as part of an insolvency plan, which would have required majority consent only) would have required significant court involvement and uncertainty of outcome. These factors made such a strategy unattractive to the sophisticated bank and bond creditors, who were familiar with UK restructuring techniques as regular dealers in distressed debt, and also to its directors.

As a result, an alternative strategy was formulated, supported by the majority creditors and shareholders. DNAG was converted into an English company and, through this process, its COMI was migrated from Germany to the UK. Then a debt for equity swap was put in place using the company voluntary arrangement procedure under the UK’s Insolvency Act 1986 (IA 1986).

The migration was achieved in steps:

**■ DNAG was converted into a German limited partnership or Kommanditgesellschaft (KG) following a vote carrying more than 75% of its shareholders at a general meeting. Under German commercial law a partnership must have two partners. Two English limited special purpose vehicles (SPVs) were incorporated and took on the role of general partner and limited partner respectively.**

■ One of the partners left the partnership, at which time, under a German law concept known as “accretion”, all of the assets and liabilities of the partnership (including key company contracts) accrued to the only remaining partner (one of the English SPVs). In this way the migration was completed and the COMI moved to England, the place of the remaining SPV’s incorporation, the location of its directors and, for a time at least, the site of its customer contracts. The IA 1986 procedures then became available to the entity.

A similar strategy was followed in the recent Schefenacker restructuring, again involving the migration of a German holding company to England, and wrapping the restructuring plan around an English company voluntary arrangement under the IA 1986.
Directors’ duties across jurisdictions

This section considers the framework of directors’ duties in England and Wales, including the changes that came into effect on 1 October 2007 concerning directors’ general corporate law duties, which may have a bearing on plans to restructure failing companies. It also considers the position and current issues surrounding directors’ duties in the context of a restructuring from a German, French and US perspective respectively.

England and Wales

The relevant directors’ duties framework in England and Wales consists of:

- Company law and common law principles.
- IA 1986 and other statutory provisions.

Company law and common law principles. Before 1 October 2007, the law relating to directors’ duties was largely derived from common law rules and equitable principles that had been developed by judges through case law. From 1 October these existing rules were replaced with provisions contained in the Companies Act 2006 (sections 171 to 177). The new provisions form a statutory statement of directors’ duties. The aim of the change is to make the law in this area more certain, accessible and comprehensible.

The new provisions consist of seven general duties that apply to directors (including, usually, de facto and shadow directors). The listed duties are not exhaustive, and other duties continue to apply (for example the duty to deliver accounts, and duties in other legislation, for instance relating to health and safety at work). The general duties are owed by the directors to the company (section 171, Companies Act) and the express duties largely restate the existing position under English common law. A notable change, however, is that shareholders are given much wider powers to pursue derivative claims against the directors on behalf of the company where there is negligence, default, breach of duty or breach of trust by them in breach of Companies Act provisions (sections 260 to 264, Companies Act).

Section 172 of the Companies Act is also an important new provision. It is a new duty that replaces the common law duty to “act in good faith in the best interests of the company as a whole” with a new duty to promote the “success of the company for the benefit of its members as a whole”. The section then sets out a series of non-exhaustive matters to which the directors are to have regard in discharging their duties. Among these factors are:

- The interests of the company’s employees.
- The impact of the company’s operations on the community and on the environment.
- The likely consequences of any decision in the long term.
- The need to act fairly as between members of the company.

There is no guidance as to how these factors are to be weighed, but it should be noted that shareholders are identified as enjoying the dominant interest.

The section 172 duty is, however, expressly stated to be subject to “any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the best interests of creditors of the company” (section 172(3), Companies Act). The effect of this subsection is to preserve the existing and developing common law rules that apply when a company is insolvent or potentially insolvent. In those circumstances, directors’ duties shift so that, in place of the interests of shareholders, directors must consider the interests of their creditors or potential creditors (see West Mercia Safeway Ltd (in Liquidation) v Dodd 1988 BCLC 250). Where these duties apply they are enforceable by a liquidator or by a creditor on behalf of the company (under section 212 of IA 1986). The common law does not give a creditor a direct claim on its own behalf against the directors.

In practice, pending case-law clarification, it is likely to be difficult in many cases to pinpoint the time at which the section 172 corporate law duty gives way to the common law duty, placing creditors’ interests at the top of the agenda. Differences of opinion can and frequently do arise as to the proper valuation of distressed businesses so that, in the absence of hindsight, determining whether a business is or is not insolvent may often be problematic. In addition, the common law is unclear as to the point of financial difficulty, short of actual insolvency, at which the duty to creditors becomes relevant.

For directors involved in planning company rescues who could potentially face derivative claims by shareholders (including any shareholders who have bought up stakes as part of a distressed investment strategy), or by or on behalf of creditors, the uncertainties concerning the interplay of the duties is another unwelcome minefield.

IA 1986 and other statutory provisions. Directors need to monitor solvency where they hold directorships of companies that may be subject to English insolvency law. This is because IA 1986 contains a number of provisions by which directors can be ordered to make a personal contribution to an insolvent company’s assets. The principal provision is wrongful trading (section 214, IA 1986). In rare cases, the fraudulent trading provision (section 215, IA 1986) can be invoked.

Directors found guilty of wrongful trading or other misconduct can also be disqualified from acting as directors for a period of between two and 15 years under powers contained in the Company Directors Disqualification Act 1986. Finally, directors of companies listed by the United Kingdom Listing Authority and admitted to trading on the London Stock Exchange are subject to additional obligations (which are beyond the scope of this article). Breach of these obligations puts the directors at risk of criminal penalty under provisions contained in the Financial Services and Markets Act 2000.

The wrongful trading provisions are intended to put the onus on directors, once insolvency is looming, to take positive steps to keep creditors’ exposure to a minimum. The provisions can only be instigated by any subsequently appointed liquidator of the company. For a claim to succeed the court has to be satisfied, on the balance of probabilities, that at some identified point before the start of the liquidation:

- The director knew or ought to have concluded that there was no reasonable
Practical tips: minimising the risk of director liability

Where a failing group has companies and places of operation in a number of jurisdictions it is vital that its directors in each jurisdiction are aware of the insolvency law framework in which they are operating. These laws will set out any constraints and limitations on their ability to continue in business and will include any provisions that can be used to bring civil or criminal claims against the directors personally. In cases of potential conflict of interest the directors may need to seek separate legal advice.

To minimise the risk of claims, the directors should consider:

■ Ensuring that they have adequate and up-to-date financial information.
■ Introducing strict controls and monitoring of the financial information going forward so that they can anticipate and deal with any potential defaults. This could include, for example, seeking waivers in advance and taking steps to recapitalise a business, if appropriate, including divesting the business of any non-key assets.

Germany

Under German law, directors face potentially more onerous duties, and ones that are less capable of being flexibly applied. Directors of companies incorporated in Germany are under a duty to file a petition for the opening of insolvency proceedings without undue delay, and in any event within 21 days of their actual knowledge of the company’s insolvency (whether on a cash-flow or balance sheet basis) (section 64, German Limited Liability Company Act 1892).

In practice, this means that the directors must file the insolvency petition promptly, unless they have credible reasons to believe that insolvency can be prevented or cured. At the end of the 21-day period the directors must file the petition, if the company is still insolvent, even if this is likely to be rectified in the future. Failure to comply with this obligation is a criminal offence with a penalty of up to three years’ imprisonment (one year in the case of negligence).

This time limit clearly provides only a very short time period for directors to put in place a rescue under German law. This often creates substantial difficulties, particularly in large complex cross-border restructurings. Other jurisdictions, such as France, also adopt the approach of imposing a strict time limit for filing (although in the case of France, the time limit was recently extended to 45 days (see below, France)).

In practice, where a struggling group has key German subsidiaries, significant focus needs to be given to monitoring the solvency of the German subsidiaries, so as, if possible, to head off any requirement to file for insolvency. A formal filing, for similar reasons to those mentioned above in the context of England and Wales, may well lead to a less favourable outcome for creditors, assuming that the company or its business is otherwise capable of being rescued.

The strict filing requirements are thought to be one of the factors accounting for the recent significant increase in use by German businesses of non-German corporate forms, including the English limited company. Overseas companies are not currently subject to the strict insolvency requirements as they are not incorporated in Germany.

However, draft legislation concerning the modernisation of German limited com-
Restructuring: directors’ duties

This article can be found on Cross-border at www.practicallaw.com/0-376-6631. Other relevant information can be found on the Restructuring and insolvency topic page, which can be accessed from www.practicallaw.com/crossborder. This includes links to content such as the following:

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Restructuring: directors’ duties

This includes where they have acted fraudulently and where they have acted in their own personal interests, causing loss to the company. Such conduct can also lead to their disqualification.

France
In France, like in Germany, directors of insolvent companies must file a request for the opening of insolvency proceedings in the local court following stringent deadlines. Since the insolvency reforms took effect in January 2006, the deadline for filing has been extended to 45 days (previously it was 15 days) from the date on which the company was insolvent on a cash-flow test basis. There is no balance sheet test for insolvency. Failure to make a filing within this timeframe may lead to the directors being disqualified from acting as directors for up to 15 years.

Directors, including de facto directors, of an insolvent company can be ordered to make a personal contribution to the company’s assets where they are found guilty of mismanagement and this is proven to have contributed to a deficit of assets. The types of mismanagement that could lead to liability have been widely construed by the French courts and include:

- Where management has failed to take steps to implement a necessary organisation of the business.
- Where management has started and continued a business with insufficient equity funding.
- Where management has failed to take action despite warnings from the statutory auditors in charge of the regular audit and ascertainment of accounts.

Directors may also have to personally compensate the company where a court has found them guilty of misconduct.

The German courts have recently shown helpful flexibility in the interpretation of the German rules requiring filings within the 21-day time frame. In a recent case, concerning a German registered subsidiary in the Collins & Aikman group of companies, the Court in Cologne held that a director complies with his statutory duty to file an opening of insolvency proceedings if the application is filed with a court of another EC member state (in this case in England, where administration proceedings were commenced) within the time prescribed by the statute, provided the foreign court accepts its jurisdiction applying the provisions of the Insolvency Regulation (Case Number 71 KN416/05).

Companies is currently being debated by the German parliament. This includes a proposal to apply the strict filing requirements to non-German companies and partnerships carrying on business in Germany (provided none of the fully personally liable partners is a natural person). It is understood that this change has been proposed partly in an attempt to deter companies from using the device of migrating their businesses to another jurisdiction to bypass the stringent German rules and take advantage of what are perceived to be more flexible restructuring procedures available outside of Germany (see box, Migration of companies).

Presumably the German legislation, if implemented, will be drafted and interpreted consistently with the operation of the Insolvency Regulation so that the filing requirement will only apply where a company has its COMI in Germany.

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Directors’ duties at common law when the company is solvent. In general, directors of insolvent or solvent US companies owe fiduciary duties to the company’s shareholders, not the creditors. The two primary fiduciary duties that directors owe are:

- The duty of care. This requires company directors to exercise the degree of care that an ordinarily careful and prudent person would exercise under like circumstances. Directors are generally protected by the “business judgment rule”, which provides that if directors inform themselves of all material information available to them, within reason, before making a business decision, courts will assume that their actions were made in good faith and that they did not breach the duty of care.

- The duty of loyalty. This requires that directors avoid engaging in conduct that gives rise to conflicts of interest and that they refrain from using their position to obtain a personal advantage (to the detriment of the company). The business judgment rule is inapplicable where there is a potential breach of the duty of loyalty.

Directors’ duties where the company is insolvent or in the “zone of insolvency”. Until recently, there has been some debate in the United States as to whether and to what extent a creditor of an insolvent company or one that was in the zone of insolvency may bring a direct claim (as opposed to a derivate claim on behalf of the company) for breach of fiduciary duty.

However, the Delaware Supreme Court has now held that creditors of a company that is insolvent or in the zone of insolvency have no right to assert claims against directors for breach of fiduciary duty (North American Catholic Educational Programming Foundation Inc v Gheewalla 2007 WL 1453705 (Del. May 18, 2007)) (Gheewalla). The court found that: “When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation and for the benefit of shareholders.”

The decision of the Delaware Supreme Court is likely to be very persuasive in other districts of the US Court.

In Gheewalla, the Delaware Supreme Court has provided useful guidance for directors of struggling companies:

- First, it has clarified that directors’ fiduciary duties continue to be owed to the company and its shareholders, even where the company is insolvent, so that individual creditors cannot bring direct claims against the directors based on breach of duty. In reaching this decision, the court commented that creditors have sufficient existing protections including those that they may have agreed contractually, such as covenants and the taking of security as well as protections under bankruptcy law.

- Second, the court agreed that where a company is operating in the zone of insolvency (a phrase it chose not to define) it was in most need of effective and proactive leadership and the ability to negotiate in good faith with its creditors. These goals would be likely to be significantly undermined by the prospect of liability arising from the pursuit of direct claims against directors by individual creditors.

The decision in this case has removed what had in some cases constituted a significant degree of negotiating leverage from creditors by removing the threat of a direct litigation claim against directors. However, creditors can still bring derivative claims against directors on behalf of the company for breach of fiduciary duties, if they can satisfy certain procedural hurdles. Where these claims are successful, the recoveries are distributed among all of the creditors.