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Briefing note February 2016

European Court finds directors of English company may be liable for breach of German company law

In a recent case Kornhaas v Dithmar C-594/14, the European Courts of Justice have held that the managing director of an English company is liable to reimburse the company's liquidator for failing to file for German insolvency proceedings within a 21 day time limit imposed by German company law. This was in accordance with the provisions of the European Regulation on Insolvency Proceedings (EUIR), which provides a framework for allocating insolvency jurisdiction amongst Member States and then decides which law applies to those insolvency proceedings. So because the English company was subject to German insolvency proceedings, certain aspects of German corporate law which were closely linked to the insolvency law also applied.

The good old days

Philip Hertz, co-head of our restructuring and insolvency group reminisces "*Life used to be so simple, if you were a director of an English limited liability company: as long as you played by the rules and avoided breaching any English laws, you would not be held liable for any action taken by the company. But now many English businesses operate using the same legal entity across different jurisdictions. In the good times, this may be great in terms of economies and growth prospects, but what may not be bargained for is that if things don't go to plan, directors may find themselves exposed to potential liabilities which they may never have known existed or certainly did not expect to apply to them.*"

It may pay to shop around for insolvency jurisdiction

Adrian Cohen, restructuring and insolvency group partner, comments "*For those who are familiar with the operation of the EUIR and the way in which it has changed the approach to cross border insolvency cases, the decision will come as no surprise. Over time the EUIR, which was primarily designed to prevent forum shopping, has in practice had the opposite effect. This has resulted in a manipulation of insolvency jurisdiction, which has had both a positive and negative effect (for example, in cases relating to individuals, it is perceived as a bad thing); now even the courts in England seem to be making a distinction between good and bad forum shopping*". In the current case there was no manipulation of jurisdiction, but simply as a matter of fact by the time the company was failing, it turned out that most of its business was conducted in Germany.

Key issues

- German company law liability applies to directors of an English company
- German liquidator was able to pursue director of English company for failing to file for German insolvency proceedings within 21 days
- Imposing German law liability does not operate as a restriction on the freedom of establishment under the Treaty on the functioning of the European Union

Therefore, the registered office presumption which is used in the EUIR for the purpose of locating a debtor's centre of main interest (COMI) which in turns founds the basis for insolvency jurisdiction, was rebutted. Generally speaking the case provides useful confirmation and guidance on the interpretation of the law applicable to insolvency proceedings under Article 4 of the EUIR. It also serves as a reminder that while it may be beneficial to effect COMI shifts to take advantage of local markets and procedures, directors also need to be aware of the additional duties and obligations which may arise as a result of that shift, deliberate or otherwise.

But don't get caught out!

By way of background, in the *Kornhaas v Dithmar* case, the liquidator was appointed in Germany in relation to a UK registered company and applied for reimbursement of certain payments made by the managing director of the company after it had become insolvent but prior to the filing of its formal insolvency. The liquidator brought the action in Germany on the basis of a provision contained in German company law (GmbHG). That provision obliges the managing director of a company to apply for insolvency proceedings to be opened within 3 weeks of the company becoming unable to pay its debts. Further, in the event that any payments are made after the company had become insolvent, the managing director must reimburse the company in relation to those payments (paragraph 64 of the GmbHG). While the German court took the view that the case was well founded as a matter of German law, it was uncertain as to whether the provision of the German company law could be enforceable against managing directors of companies that were established in other Member States but had a COMI in Germany. In addition it was unclear as to whether the action taken by the liquidator could be considered to restrict the freedom of establishment as prescribed by the Treaty on the Functioning of the European Union.

The issues for the European Court

The two questions referred by the German Courts to the ECJ were:

1. Is the action governed by German Law within the meaning of article 4 of the EUIR?
2. Does the action infringe freedom of establishment under articles 49 and 54 of the Treaty on the Functioning of the European Union (2012/C326/01)(TFEU)?

The applicable law may not be the law you were expecting!

In relation to the first question the ECJ has previously held in the case *Re H v HK C-295/13* that an action based on the same German company law provision i.e. paragraph 64 of the GmbHG, is an action deriving directly from insolvency proceedings and closely connected with them. It categorised such a provision as being covered by insolvency law for the purposes of Article 3. In this case, the ECJ held that the same analysis applied for the purposes of Article 4, which determines the conditions for the opening of the insolvency proceedings. In this case it was considered that Article 4 included the preconditions for opening, the rules which designate the persons who are obliged to commence the process and the consequences of failing to file. It was also considered that the purpose of paragraph 64 of the GmbHG was intrinsically linked to one of the objectives of all insolvency proceedings i.e. to prevent a reduction of assets to the estate so that the company's creditors may be satisfied on equal terms. As such it was held that paragraph 64 of the GmbHG fell within the scope of Article 4 of the EUIR.

In relation to the second question, the ECJ took a very narrow approach and held that while there may be instances where a Member State refuses to recognise the legal capacity of a company formed within another Member State, which may constitute a restriction of freedom of establishment and be incompatible with TFEU, and where there were also circumstances where penalties attached to minimum capital requirements which could also infringe such freedoms, the provisions of paragraph 64 did not concern either. Looking at the point very narrowly and based on previous decisions, it held that paragraph 64 of the GmbHG did not call into question the legal capacity of the debtor, nor did it relate to any minimum capital requirement. It held that, as paragraph 64 in no way concerns the formation of a company or its subsequent establishment in another Member State and does not affect the freedom of establishment, it did not preclude the application of the German company law provision to the managing director of a company established under the laws of England and Wales which is the subject of insolvency proceedings in Germany.

What the case didn't address

David Towers, a partner in our restructuring and insolvency group in London remarks "*The case does not consider whether the application of German law operates to exclude or usurp entirely similar provisions which may continue to apply as a matter of English law. For example, could the German liquidator bring a claim for breach of duty under English law or, if secondary proceedings were commenced in England, could the liquidator also bring a wrongful trading or a preference claim under the insolvency legislation here in respect of those payments*?" In the current case it made sense to pursue the director in Germany, but for other cases, where for example the defendants and their assets are located in England, it may have been more straightforward to pursue them in England using English law provisions. In this regard, although a German liquidator would be recognised in England and would be able to rely upon duties set out in the Companies Act 2006, he would not be able to rely on English insolvency law provisions without commencing an English law process first.

The case also says nothing about whether the obligations to file for insolvency proceedings imposed by the German company could be satisfied by a director making a filing for an English process. One assumes so, given the fact that under the EUIR, main proceedings taking place in one Member State are automatically recognised in another. Stefan Sax, head of our restructuring and insolvency group in Frankfurt comments "*this scenario has been before the Courts in Germany before in 2005 in a case relating to the Collins and Aikman Group. In that case English administration proceedings had been opened in England in relation to a German company within the group, but the directors of the German company were concerned that the German law duty to file within the prescribed time limit would not be met and they would be held liable, as such they commenced a secondary insolvency process in Germany. The German court held that it was unnecessary to do so, as the English administration proceedings had the same effect in protecting creditors and ensuring an equal distribution amongst creditors. It is not however free from doubt in other Member States where similar obligations may apply and where there is also an establishment, formal proceedings may be the only way of being certain of not incurring liability. Nor does the case consider whether the criminal sanctions relating to a failure to file also apply*."

Development in the Recast Regulation: actions derived or closely linked to insolvency

The conundrum in this case may have been more straightforward post 26 June 2017. This is because there is an explicit reference in Article 6 (the successor to Article 4 of the EUIR) of the Recast Insolvency Regulation (effective in relation to insolvency proceedings commenced after 26 June 2017) which states that the Member State where insolvency proceedings have been opened also has jurisdiction for any action which derives directly from and is closely linked with them, such as avoidance actions. In addition Article 6(2) of the Recast Regulation allows the insolvency practitioner to bring an action which is related in civil and commercial matters against the same defendant before the courts of the Member States where the defendant is domiciled or, where there are several defendants, before a court within which any of them is domiciled. The provisions go on to state that actions are deemed to be related where they are so closely connected that it is expedient to hear them together to avoid the risk of irreconcilable judgments resulting from separate proceedings. So for example in the current case, the German liquidator may have brought the same action in England.

What's next? Directors' liability in the different Members States

This case reminds us of the various liability regimes that are in place across the different Member States. It also considers the potential conflict that can arise when the liability regime in place of incorporation is at odds with the regime that operates in the insolvency jurisdiction. (See our summary tables below for the different time limits which apply in some of the key European jurisdictions and the types of liability they may attract in an insolvency context.) These differences are something which has not gone unnoticed at an EU level. For example under Article 90 of the Recast Regulation, the Commission was obliged, by no later than 1 January 2016, to submit to the European Parliament, the Council and Social Committee, a study on the cross border issues in the area of directors' liability and disqualifications, so we may see some developments on this particular aspect in the future. But for now, directors should ensure that they seek advice from all the relevant jurisdictions.

The importance of this has been exemplified most recently in the restructuring of Scholz Holding GmbH where this firm is advising the Management Board as Restructuring Counsel. In this case, the company, a German registered company, has moved its COMI to England for the purposes of taking advantage of the optimal restructuring pathway open in this jurisdiction. In a mirror image of the Kornhaas case, the directors here can take some comfort, in our view, that their insolvency related duties will be circumscribed under English law (post COMI shift).

Restructuring and insolvency trends in Europe

Time limits for filing for insolvency					
England & Wales	**France**	**Germany**	**Italy**	**Spain**	**The Netherlands**
No express time limit Failure to take action which results in a loss may give rise to action against directors personally.	Obligation to file for either a judicial rehabilitation or liquidation proceeding within 45 days of cash-flow insolvency (except if a conciliation proceeding has been filed for).	Obligation to file immediately when unable to pay debts or over indebtedness. Filing may be postponed for up to 21 days if reasonable expectations exist that insolvency can be overcome.	No express time limit Failure to take action which results in a loss may give rise to action against directors personally.	Obligation to file within 2 months of insolvency. Failure to comply assumes that bankruptcy is carried out negligently.	No express time limit Failure to take action which results in a loss may give rise to action against directors personally.
Types of liability for directors in an insolvency					
For breaches of duties, wrongful trading and fraudulent trading	For cases of mismanagement that has contributed to the deficiency of assets of the debtor or to the insolvency of the debtor (e.g. late filing for insolvency proceedings).	For failure to file for insolvency, for any payments made to third parties after the company becomes insolvent and for any new agreements which the company is unable to fulfil.	For breaches of duty and failure to preserve the company's value if that failure results in a loss to creditors. Criminal liability for directors who either: (i) distracted, disguised or voluntarily lost the assets; (ii)delayed the declaration of bankruptcy; or (iii)disguised the company's financial distress or its insolvency state in order to obtain financing.	For case where insolvency is considered as negligent, and where directors have contributed to the insolvency.	For mismanagement, wrongful distribution, fraud or if the directors have contributed to provoke the company's insolvency.

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