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THE DUTIES AND LIABILITIES OF COMPANY DIRECTORS IN INSOLVENCY PROCEEDINGS: A COMPARATIVE ANALYSIS

Master's Thesis

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ABBREVIATIONS

EU – European Union

CJEU – Court of Justice of the European Union

The EU Member-states/ Member States – Member States of the European Union

Recast Insolvency Regulation/ New EIR – Recast of the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings

Old Insolvency Regulationt – Council Regulation EC No 1346/2000 on Insolvency Proceedings

Kornhaas v Dithmar case/ Kornhaas case – Judgment of the Court of Justice of the European Union (Sixth Chamber) of 10 December 2015 - Simona Kornhaas v Thomas Dithmar als Insolvenzverwalter über das Vermögen der Kornhaas Montage und Dienstleistung Ltd

INTRODUCTION

Statement of the topic. When it comes to the issue of the effective functioning of an undertaking or any company, no matter in what sphere of the economy it operates, what production or service provision it accomplishes, one of the key elements of the success of such entity is an effective management. Despite having a supreme authority within the structure of a company a general meeting of shareholders, the day-to-day business and decision-making process is conferred upon the director of the board of directors. In such situation, the existence of the effective mechanism of the duties and liabilities of directors gains the extreme importance.

It is still disputed among the scholars to whom precisely such duties of the director are owed – only to the shareholders of a company or to the broader and more blurred category of people – its stakeholders which also includes the creditors, consumers of such company etc. As regards the question of the content of such duties, the scholarly approach is more homogeneous. The two main duties including the duty of care and duty of loyalty can be found almost in every jurisdiction across the EU and abroad. It is only the extent which such duties encompass varies.

The content and scope of the director's duties remain without any changes as long as the company is doing well. However, things change in the vicinity of insolvency. When some company lacks enough liquidity to handle with their current and possible future contractual obligations directors have to be extremely careful. Various European Union countries provide in their national legislation for the additional duties like the duty file in a timely manner for the commencement of the insolvency proceedings or duty not to enter any risky transactions in order not to deplete the company's assets and to assure that the rights of the creditors are maintained. There is a shift towards the interests of the creditors and not shareholders of a company, duties of directors are now owed to them. Moreover, such new obligations for the company's directors are prescribed mostly in the national insolvency law, whereas the general duty of care and duty of loyalty are mainly the part of the company law bundle of legislation.

Such interplay of the insolvency and company law when a company approaches insolvency is typical for many EU jurisdictions. And that is where the potential problems may arise, especially when we are dealing with cross-border issues. In cases where a company has its registered office in one member-state, but de-facto the management is performed from another country the question of the location of the legal rules related to the director's duties and liabilities may become significant, especially in the light of the potential question of the enforcement of the director's duties.

When dealing with the process of defining of the applicable substantive law it is important to emphasize that company law is determined according to the state of incorporation across the European Union, whereas insolvency law applies on the basis of the COMI. Both Regulation (EC) No 1346/2000 on insolvency proceedings and Regulation (EU) 2015/848 on insolvency proceedings (Recast Insolvency Regulation) use the concept of COMI to determine the national jurisdiction courts of which are empowered to conduct the insolvency proceedings and therefore apply the provisions of the national insolvency law.[1]; [2] When these two jurisdictions do not coincide, the possible regulatory gaps may appear.

While drafting the New European Insolvency Regulation one of the main aims was to overcome the problem of "forum shopping".[3] However, the situation of certain legal uncertainty remains as the new Insolvency Regulation still does not provide a clear answer as regards the possibility to refer to the provisions concerning director's duties and liabilities in case when such are located within the bulk of a company law acts.

During the current research that is devoted to the issues of the director's duties and their modifications in the vicinity of insolvency, the considerable attention will be made to the above-mentioned problems of cross-border issues that are related to the enforcement of the director's duties and liabilities.

Scientific research problem. Analysis of the literature and legal acts that are relevant to the topic of the master thesis indicates that there is a gap in the regulation of the question regarding the choice of law applicable in respect of the duties and liabilities of a companies' directors due to the situation that in many national jurisdictions of the EU member-states such duties are located in the different legislative acts: questions regarding the general duties of care and loyalty are regulated by the provisions of the company law, whilst obligations that arise before a company directors in the vicinity of insolvency are set by the relevant insolvency law provisions. Such separation may lead to the situation of a non-application or the improper application of the relevant national substantive law provisions and, as a result, hamper the satisfaction of the creditors' and shareholders' rights in the process of trying to sue the director in the insolvency proceedings. This can also lead to the situation of the so-called "forum shopping" when the company moves its COMI to another jurisdiction with the more favorable company law legislation in regards the director's duties.

[1] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), 236.
[2] "Centre of Main Interest (COMI)", *Thomson Reuters Practical Law* (2017)
[3] Recast of the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, *Official Journal of the European Union, L 141/19, 05/06/2015, 19–72*

In the light of the adoption of the new Insolvency Regulation, the important question arises: are the legislative tools offered by the Regulation sufficient enough to effectively solve the question raised above? The current research is aimed at answering this question.

The relevance of the master thesis. One of the purposes of the adoption of the new EU Insolvency Regulation (Recast) was the need for more effective regulation of the cross-border elements in insolvency proceedings involving companies that has business activities in another EU country than in one they are usually based and to combat the problem of such thing as "forum shopping".[4] New Insolvency Regulation, in its entirety, will contribute significantly to more flexible and efficient legal regime in insolvency proceedings. However, some provisions of the Regulation regarding the choice of applicable substantive law and the newly introduced article concerning the jurisdiction for actions deriving directly from insolvency proceedings and closely linked with them[3] contains a certain ambiguity and requires further scientific research to be conducted. Apart from the Regulation itself, the existing national and CJEU's case law needs to be analysed from the standpoint of whether it can provide an efficient solution to the situation of the possible lack of legal certainty in this field.

Scientific novelty of the master thesis. Previously many scholars paid careful attention towards the problem of "forum shopping" in insolvency law related matters and the newly adopted Recast of the European Insolvency Regulation also address this issue. However, such an element as a "forum shopping" from the perspective of director's duties and liabilities still constitutes certain concerns and the EU member-states case law shows that national judicial authorities sometimes face problems in regards to the question of the applicable substantive law in insolvency proceedings which involve a cross-border element.[4] It is especially relevant when the duties and liabilities of company directors can be found in a different set of legal acts – company law and insolvency law. In such situation, the necessity for the additional research of the current problem seems to be useful.

Review of the literature. The research boundaries of the Thesis include the analysis of the general duties of directors when the company is solvent; comparison of the EU Member-states' approach towards the new duties when the company is insolvent and the analysis of the core issue of the Thesis – the legal uncertainty in the field of the substantive law that is applicable in cross-border cases. The existing literature in the sphere of the general duties of

[4] Recast of the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, *Official Journal of the European Union, L 141/19, 05/06/2015, 19–72*

[3] Article 6 of the Recast of the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, *Official Journal of the European Union, L 141/19, 05/06/2015*

[4] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 76.

directors include the works of such scholars like prof. Canh; Hopt etc. The researches made by the London School of Economics and the Leeds University on the comparative analysis of the directors' duties within the EU are also among the notable works in the current field. In addition to that, the question of the legal uncertainty in the field of applicable law on the duties of directors in the vicinity of insolvency has been widely analyzed by scholars and practitioners including prof. Lennarts and prof. Ringe who conducted a comprehensive analysis of the existing CJEU's preliminary rulings in the relevant field as well as the historical aspects of the preparation of the New EIR.

The aim of the master thesis. The aim of the master thesis is **to compare** the approaches of various EU Member-States towards the coordination of the national company law and insolvency law provisions on the duties of directors and their liability, and **to propose** possible solutions for the more effective regulation of the examined issues.

The objectives of the master thesis. In order to achieve established aim of this master thesis the following tasks have to be carried out:

1) To scrutinize the possible approaches and experience of the EU member-states towards the legislative regulation of the director's duties and liabilities:

a) To analyze the scope of the director's duties and liabilities:

i) in the times when a company is solvent;

ii) how they change in the vicinity of insolvency;

b) to identify the core problems that may arise in connection with the director's duties and liabilities in the case when they are located in a different set of legal norms.

2) To identify the core problems that may arise in connection with the different approaches towards the determination of the applicable substantive law in the cross-border cases in insolvency proceedings:

a) To make an analysis of the measures proposed by the European Union legislation in respect of the problems concerned;

b) To conduct a research and analysis of the existing court practice and scholarly articles that can indicate the existence of the problem and/or propose the mechanisms that will provide the effective solution of the problem;

c) To elaborate the possible solutions to the existing deficiencies in the current legislation regarding the concerned topic, if any.

The practical significance of the master thesis. The current research will be useful for scholars and practitioners in the field of insolvency who deal with the issues of "forum

shopping" and work closely with the question of the director's duties and liabilities and the enforcement of such duties in the cross-border cases.

The master thesis can also be useful for the students studying insolvency law who wants to deepen their knowledge in such complicated issues as the interrelation of company law and insolvency law in cross-border insolvency proceedings.

As regards the European Union policymakers, this research presents a value from the perspective of possible amendments to the current EU legislation in the sphere of the insolvency law as it contains advice and proposals for some minor but probably useful amendments to the new European Insolvency Regulation with the aim of making it more flexible and clear for the lawyers who work in this sphere when applying provisions of applicable substantive law in cross-border cases.

The defended statements. 1. The use of the international private law rules in regards to the determination of the applicable law and rules laid down in the Recast Insolvency Regulation can create legal uncertainty in respect of the applicable law on the director's duties. 2. The existing solutions to such legal uncertainty problem that are contained in the existing case law and the Recast Insolvency Regulation are not efficient enough and require further consideration.

Methods used in the master thesis. Several methods will be used during the current scientific research.

First, one of the main methods will be the method of data collection and data analysis, due to the necessity of studying and analyzing the big amount of legal texts, case law as well as scholar's articles. As a result, the collected data will be analyzed, structured and some conclusions will be deduced. In addition to the analysis of various legal texts, case law, and scholarly articles, the additional data will be collected by means of sending a relevant questionnaire to various law firms specializing in the field of company law and insolvency law across the European Union.

Second, as it stems from the title of the master thesis, one of the purposes of the current research is to make a comparative analysis of different approaches towards the regulation of a considered problematic. Therefore, a comparative method will be used as well in order to analyze and compare different jurisdictions, both European and those outside the Union, as regards the effectiveness of their approach towards the regulation of the issues that are subject to the current research.

Another important scientific method is a linguistic one which is crucial when determining the significant concepts that are used by the legislative authorities in different jurisdictions when regulating some specific issues related to the topic of the current research. It

allows to avoid the unnecessary misunderstanding when analyzing various legal concepts implemented in the text of legislative acts of different jurisdictions and brings additional clarity while interpreting the intention of a legislator.

Another used method is a historical one that allows us to understand and properly interpret the dynamic of legislative changes while analyzing various legal acts both at the EU and national level.

Also, another important method that is worth mentioning is a logical method that can be seen as some kind of an interconnector between all the above-mentioned methods and allows us to make the complete vision of a problematic that is subject to the current analysis and to elaborate some reasonable solutions to it.

The structure of the master thesis. It consists of several parts:

In the first part of the master thesis, the general description concerning the scope of the duties and liabilities of directors together with the changes that occur as a result of a company approaching insolvency will be enlightened.

During the second part of the research, the comparative analysis of the different national approaches towards the allocation of the director's duties in the different legislative acts will be performed. Also, the problem of the scope of the applicable substantive law in the cross-border cases and measures proposed by the new European Insolvency Regulation will be covered. EU's court practice in the relevant field will be analysed.

1. OVERVIEW OF THE DIRECTORS' DUTIES AND THEIR CHANGES IN THE VICINITY OF INSOLVENCY

The general part of the master thesis will be dedicated to the several issues which are important for the fulfilment of the objectives of the current research. One of the key points among the objectives that has been set up in the introductory part of the thesis is the necessity to identify the existence or, on the contrary, the absence of the practical obstacles in the question the application of the substantive law related to the duties and liabilities of company directors in the vicinity of insolvency when we are talking about the situations that involve a cross-border element. In other words, are there any hurdles in the question as to which national substantive law to apply to the insolvent company and its directors when we have a company that has been established in the one EU Member-state while its COMI (Centre of Main Interests) is located in the other EU Member-state?

It would be accurate to say that for such obstacles to, at least theoretically, be in place, there has to be a difference in the substantive legal rules regarding the subject at hand (in our case, the legislation on the duties of company directors) in different countries – members of the European Union. Moreover, when the court, that is empowered to open the insolvency proceedings, will be determining the law applicable to the case, there has to be some rules of the conflict of laws elaborated in the course of development of the international private law that will lead to either the substantive law provisions of the EU Member-state different from the one where the court seized is located, or lead to the certain situation of a deadlock i.e. where there is a uncertainty as to what legal act to apply in particular. Naturally, such situation would have been impossible even theoretically, if there was a single uniform law (for example, in the form of a directive or regulation) in the European Union as regards the duties and liabilities of company directors. In the author's opinion, such a situation would contribute to the European Union's overall convergence and would have a beneficial impact on the functioning of the EU's existing "four freedoms" and, more precisely, the freedom of establishment. However, that is not the case at least for now, thus we will proceed in our research.

Looking ahead a little bit, it is worth mentioning that the national courts of the EU Member-states have already faced the so-called deadlock that was described in the previous paragraph. The deadlock was quite significant that subsequently led to the appearance and development of the CJEU's practice[5] on the matter. The Recast Insolvency Regulation 2015/848[6] has also addressed

[5] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806;

[6] Recast of the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, *Official Journal of the European Union, L 141/19, 05/06/2015, 19–72*

the question. All these issues will be described in details later in the special part of the current Master Thesis.

Taking into consideration all the above mentioned, in order to understand the nature of the possible obstacles in the application of the national substantive law and the discrepancies that exist between the provisions of the national law of the EU Member-states, to devote the general part of the master's thesis to the overall analysis of what are the director's duties; are there any changes to the director's duties as the insolvency of a company is becoming imminent and if yes, how precisely do such duties change in the vicinity of insolvency? And we will start with the brief description and analysis of the general duties of company directors.

1.1 GENERAL DUTIES OF COMPANIES' DIRECTORS WHEN THE COMPANY IS SOLVENT

In this section, we will be briefly covering the issues of "general" duties of company directors – those which directors should obey while managing an absolutely solvent and "healthy" company.

First of all, it is worth mentioning that company directors are "managers" of legal entities, whose main function is to manage the company's day-to-day business activity. It is not a universal standard, but still, quite a frequent situation, that "normally", especially in the big public companies, directors are people who have no other ties with a company except the contractual relations. Sometimes directors may also act simultaneously as company's shareholders, but this is by no means a precondition for them to be adopted in a capacity of a director. All decisions that are crucial for the functioning of a company (like the business direction or a long-term strategy that a certain company should follow) are taken by the general meeting of the shareholders who invested into the company by acquiring shares and are interested in having those shares to be of highest value possible. They have real economic interest in adopting such decisions in a wise manner. Contrary to that, directors of a company (if they are the "outsiders" to the company) usually have nothing to lose, apart from their reputation, in case the decisions they made have led to the financial difficulties and the subsequent state of insolvency of a company. That is why the doctrine of director's duties have been developed and allowed the shareholders, creditors and other stakeholders of a company to ensure that the directors, in case they made some unwise decisions or even acted with an intention to harm the company, would be liable for the harm and obliged to reimburse it even with their own assets.

The social relations between the directors of a company and the company as a legal a are typical relations between an agent and its principal where a director is a former and shareholders and sometimes other stakeholders are the latter. That is why it is common to find in various

scholarly articles the company director's duties under the "umbrella" of such an institute of corporate law as fiduciary duties. In relation to the directors of a company, shareholders act as "employers" who basically delegate the right to adopt the company's decisions in a course of its day-to-day business and to implement some short-term strategies to a single director or a board of directors or the management board.

As there are currently 28 Member-states in the European Union, the approach towards the regulation of the duties of directors varies quite significantly from country to country. For example, some EU Member-states locate the director's duties in the bunch of laws and regulations that are part of the general body of civil law or corporate law (like Civil Code or something similar) while other countries tend not to strictly codify the duties and obligations of the company directors, but rather rely on the existing national courts' practice in the relevant field. Such distinctions in regulatory approaches are dictated by the well-known general division of European countries into two big groups with different approaches towards the structuring of a legal system: countries which belong to the so-called "Common Law system" and "Civil Law countries" – those whose legislative system was influenced by the Romano-Germanic legal tradition.[7] Notwithstanding such a difference in historical roots of different Member-states and the level of codification of their national legislation, when the question concerns the duties of company directors, those rules, and standards of behavior of such persons are predominantly codified.[8]

As we highlighted the issue of the principal-agent relations in the previous paragraph, it is also worth mentioning that in general the addresses of director's duties i.e. the agents in our case are the so-called "de-jure directors" – the ones that are directly employed or appointed by the general meeting of shareholders to be responsible for the daily management of a company.[9] However, there might be some situations where the business activity of a company is managed by a person or group of persons who are not formally appointed but factually perform the management of the company's businesses. Such a situation is quite dangerous as it allows the persons who in fact perform the functions of a company director to escape from personal liability in a situation where the company is near or faces insolvency. That is why the EU Member-states do recognize such persons as those who also fall into the category of people obliged to follow at least some of the duties and obligations prescribed for company directors.[10] Such persons are commonly referred

[7] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), viii
[8] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), viii
[9] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), ix
[10] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), ix

to as "de-facto" directors or "shadow" directors.[11] Therese two definitions, though, are not interchangeable as the meaning behind each of it is a little bit different. De-facto directors are those persons who manage a company's day-to-day business and adopt managerial decisions while not be formally appointed and authorized by the general meeting of shareholders to do such kind of activity. Shadow directors are those persons who influence the decision-making process of formally appointed directors by virtue of giving sort of advice or instructions.[12] This last category of persons reveals the greatest concerns as shadow directors are usually the ones who are most difficult to trace. For example, in a situation where we have a group of companies and a parent company or its directors are involved in the strategic decision-making process which influences all subsidiaries of a parent company.[13] Formally, such a decision may be embodied as a decision made by the director or board of directors of the subsidiary company, but the reality is different. This is the problem to be reckoned with and no clear answer can be found in any national legislation of the EU Member-states whether the managing bodies or persons of the parent company can be held liable to the same extent as the subsidiaries' de-jure directors.[14]

Before we move further into the mere identification and description of the general fiduciary duties that directors have to follow under the normal circumstances of the functioning of a company, there is a necessity to briefly shed some light on the question of who is the beneficiary of the duties that directors possess.

The universal approach to this question is that directors owe their duties directly to the companies that they represent. Notwithstanding the fact the earlier in this section we already mentioned the "fiduciary" relations between the shareholders and the company directors, it is important to mention that the duties of directors are owed to a company directly. Shareholders appear in this scheme only by virtue of composing the main decision-making organ of a company – the general meeting of shareholders. This body adopts a decision on the appointment of a director or directors of the board of directors, but it is the company as a legal entity to whom the duties are owed.[15]

Though sometimes there can be exceptions from the rule mentioned above, especially if we are talking about the EU Member-states which belongs to the group countries of Common Law origin. In such jurisdictions, the duties of company directors can be owed not directly to a

[11] "Duties of the Directors of Companies in Financial Difficulties." 2014. *Slaughter and May*, 2014, 4
[12] "Duties of the Directors of Companies in Financial Difficulties." 2014. *Slaughter and May*, 2014, 4
[13] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), ix
[14] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), ix
[15] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), ix

company, but to its shareholders. Such a scenario usually occurs if there exists some special "factual relationship" between the director and the shareholders. Such factual relationship exists when a director or directors directly approach a shareholder or group of shareholders proposing the latter to enter some particular transactions.[16] In such a situation a shareholder or group of them enter some particular transaction that is proposed by directors directly and circumventing the company itself. That is why a legislator in some Member-states of the European Union has foreseen such a scenario and adopted a specific rule. The issue of the addressees of the company directors' duties is an important one in the context of our research as further on we will see how things are changing when a company approaches insolvency.

Generally, directors of companies are subject to two main duties which they owe to a company and which can be found in every national legal system of the EU Member-states: duty of care and duty of loyalty. Duty of care means that there are some requirements for company directors to act diligently (with care) during the managing of a company and adopting day-to-day business decisions. Duty of loyalty is all about an obligation for company directors to act in good faith in respect of the company's interests and not to enter into situations of conflicts of interest between such of a company and director's personal ones.[17]

1.1.1 Duty of loyalty

Stands for the obligation of a director not to act and adopt decisions that are contrary to the interests of a company – avoid conflicts of interest. This duty has experienced an extensive development in Common Law countries and embraces various situations where the interests of directors may be in conflict with the interests of a company. Directors must then avoid making any decisions that might be contrary to the company's interests.[18] Subsequently, the concept of the duty of loyalty has spread to continental Europe and is now known well in jurisdictions of Civil Law origin such as Italy, France, Germany, Switzerland etc.[19] The complicated thing for countries with Civil Law tradition is that usually, it is quite hard to codify all the possible examples of conflicts of interest that may occur in relations between the principal (a company) and its agent (directors). Common Law countries regulate such things through the courts' practice on a case-by-case basis. However, nowadays all of the Civil Law countries mentioned above do have some

[16] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), ix

[17] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 45

[18] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), xi

[19] Klaus J. Hopt "Comparative Corporate Governance: The State of the Art and International Regulation." *Law Working Paper* N°.170 (2011), 40

corporate law provisions or also a case law on the matters at hand. [20] The extent of the duty of loyalty is quite similar in different EU Member-states, regardless of whether such states belong to Common Law systems or Civil Law. For example, both the United Kingdom and Germany (who represent different legal systems: the former – Common Law, the latter – Civil Law) recognize an act of adopting a decision that damages a company while simultaneously benefits the director himself as a breach of the duty of loyalty.[21] At a first glance, there might be an impression that the duty or standard of loyalty hampers the directors' freedom to act and make decisions while running the day-to-day business, however, the existence of such duty is justified and necessary because at the same time such a duty reduces the chance of directors being disloyal in respect of a company. Even more, the duty of loyalty reduces the chances of directors to be subsequently sued by the company (through their representatives like shareholders) on the basis of the adopted decisions. It happens due to the existence of a standard that allows determining whether the adoption of a certain decision by the company director was done in violation of the duty of loyalty or not as it involves a criterion of personal gain or personal interest. Obviously, a particular decision made by a director will not be in breach of the duty of loyalty if there is no evidence of the existence of the abovementioned personal interest or gain.[22]

Among the most notable examples of the breaches of the duty of loyalty (conflicts that may arise between the interests of a director and company interests) is an exploitation of the corporate opportunities. As we mentioned above, directors are decision-makers that act that manage the day-to-day business activity of a company. That is why there is no surprise that they are the first persons who aware of the "inside" information of a company, they have the deep knowledge of the "minutiae" of the company's activity and it may be tempting to use such information and knowledge for private gain. The second most common issue that relates to the violation of the duty of loyalty is the so-called "self-dealing" or, in other words, the related-party transactions.

The self-dealing can take various forms like:

a) A company director may, for example, act as a contractual counterparty to certain transactions. Such a transaction may involve the sale or property directly to its director or his/her relatives, loan such property to them etc.;

[20] Klaus J. Hopt "Comparative Corporate Governance: The State of the Art and International Regulation." *Law Working Paper* N°.170 (2011), 40

[21] Andreas Cahn, David C. Donald. "Comparative Company Law. Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA." *Cambridge University Press*, (2010), 333

[22] Andreas Cahn, David C. Donald. "Comparative Company Law. Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA." *Cambridge University Press*, (2010), 333

b) Another frequent situation is when a director receives some kind of a "bonus" or compensation for the successfully performed transaction (even if such bonus is paid or delivered to the director by the third party to the transaction) etc.[23]

Another possible situation that may lead a company director to a breach of the duty of loyalty is connected with the issue highlighted above – the "insider's knowledge or information that may be used by a director for his/her personal gain. Such situation may occur if a director in one way or another competes with its own company:

a) While being a director in one company, such person runs its own company or manages another business that is acting in a competing field. Of course, the mere fact of a director managing two separate companies in one niche of the field of economic activity does not itself mean that there is a breach of the duty of loyalty, but such director needs to be extremely careful with the insider information and knowledge that he or she has;
b) By using an information received in the course of daily company management for personal gain.[24]

Either of the above-mentioned examples involves a degree of personal interest at the director's side and are recognized as being against the law.[25]

1.1.2 Duty of care

Companies directors must ensure that they devote care, time, efforts, skills and diligence that is sufficient to perform an effective management of a company they work at. The standard of care differs from state to state in the European Union, but all the Member-states provide in their national legislation some objective criterions to assess whether a director devoted sufficient level of diligence while managing a company. For example, the United Kingdom provides in its Section 174 of the Company Act 2006 the criterions for the duty of care as follows:

1) "A director of a company must exercise reasonable care, skill and diligence.

2) This means the care, skill, and diligence that would be exercised by a reasonably diligent person with

[23] Andreas Cahn, David C. Donald. "Comparative Company Law. Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA." *Cambridge University Press*, (2010), 333
[24] Andreas Cahn, David C. Donald. "Comparative Company Law. Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA." *Cambridge University Press*, (2010), 333
[25] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), xi

a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and

b) the general knowledge, skill and experience that the director has".[26]

This is a good example of such an objective criterion – the criterion of a "reasonably diligent person of the same kind". Behind this standard of a diligent and reasonably expected person, there is also some other kind of peculiarities that need to be taken into account while assessing the actions conducted and decisions made by the company directors from the perspective of possible violation of the duty of care. For example, if a director has some specific qualifications of some knowledge or another background in management or any other relevant skills, he or she should also use those skills and knowledge while adopting decisions as a manager of a company. Such a possession of certain specific skills and knowledge represents a subjective criterion and in an ordinary negligence actions cases, courts usually hear evidence from an expert witness as regards the existence of such special knowledge and skills at the side of a company director.[27]

However, the approach described above is not a universal one among the EU Member-states. Some scholars, like A. Cahn and D.C. Donald, who conducted their research in the sphere of directors' duties and, specifically, the duty of care and its application in the European Union have concentrated their attention on the two Member-states of the EU of different legal tradition: United Kingdom (a Common Law country) and Germany (a country of a Civil Law tradition) and have come to the conclusion that the courts' practice does not always follow the approach of assessment of both objective and subjective criterions. For example, both German courts and the UK's ones tend to make a presumption that disinterested directors making business decisions in good faith have, nevertheless, met the duty of care "absent egregious mismanagement".[28] Such a tendency of assessing the requirements for the company directors' duty of care in not so stringent manner, as well as the reasoning behind such courts' behaviour, is itself interesting for a separate research, but as current Master's Thesis is devoted to the issues of directors' duties in the vicinity of insolvency, the author, thus, will not proceed deeper into the elaboration of the issue at hand.

Taking into consideration the above-mentioned, it is possible to enumerate several different approaches among the EU Member-states in respect of the assessment of the possible violations of the duty of care by the company directors. The required standard of care can be assessed from the strictest standpoint where both the objective and subjective criterions are taken into

[26] Section 174 Companies Act 2006

[27] Andreas Cahn, David C. Donald. "Comparative Company Law. Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA." *Cambridge University Press*, (2010), 370

[28] Andreas Cahn, David C. Donald. "Comparative Company Law. Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA." *Cambridge University Press*, (2010), 370

consideration; it also can be done from the intermediate standpoint – only the objective standard of care is taken into account and from the less strict approach where the reduced standard is applicable.[29] Different approaches are used across the EU Member-states with the majority of them applying either the objective/subjective or the objective standard. Only four EU national jurisdictions [namely Ireland, Cyprus, Greece and Luxembourg][30] provide for the less stringent approach by applying the reduced standard. As a result, the level of convergence between the EU Member-states is quite significant in this regard.[31]

Another one important issue, that is related to the duty of care, to mention is the so-called "business judgment rule". This rule originally emerged in the US case law and consists of a presumption that company directors, while performing the day-to-day business activity and adopting business decisions, act being informed about the existing financial situation of a company, in good faith and in the honest belief that the action taken or decision adopted by them will be beneficial for the company.[32] Such a presumption is a rebuttable one and it is up to the claimant to do that. If the presumption is not rebutted in the course of the court proceedings, judges will respect the directors' business decisions. However, if the presumption is rebutted, then it is the obligation of a director to prove that the contested transaction or business decision was beneficial for the company.[33]

As regards the Members of the European Union, the majority of the Member-states decided not to follow the US approach and did not implement similar rule into their national legislation. Only five EU Member-states [Germany, Portugal, Romania, Croatia and Greece] have adopted some codified variation of a business judgment rule.[34] Even though five European jurisdictions do contain some sort of codification and recognition of the business judgement rule, that does not lead to the existence of lower risk for companies directors to be held liable for their business decisions as such an advantage of the business judgement rule as non-reviewability of directors' decisions is usually offset by the existence of the other rules that shift the burden of proof to the companies' directors.[35]

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[29] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), x

[30] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), 93-94

[31] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), x

[32] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), xi

[33] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), xi

[34] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), 108-116

[35] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), xi

1.1.3 Other duties (implicit?)

Before we move further to the next issue of the possible changes in the scope of the duties of directors when a company encounters insolvency, there is one controversial issue to mention – implicit directors' duties. In the previous sections of the Master's Thesis, we have described the very common duties of company directors – the duty of loyalty and duty of care. Those duties are presented in every national legislation across the European Union. However, some scholars who devoted their researches to the topic of duties of directors have suggested that the duties of company directors are not limited to the above-mentioned two big pillars: duty of care and duty of loyalty and that there can be found some implicit duties like the duty to prevent the situation of the insolvency of a company.

Most EU Member-states' national legislation does not contain specific provisions regarding the duty to take preventive actions to avoid the state of insolvency of a company or to identify the possible risks that may lead to such state. However, some scholars, like G. McCormack, A. Keay, who conducted their research in the sphere of business insolvency for the University of Leeds, argue that as the directors of companies have the duty to manage the company responsibly (the duty of loyalty), they are under the implicit duty to ensure solvency of the company. In support of this theory it is stated that, for example, according to the Second Directive, particularly article 19, the EU Member-states require the directors to convene a meeting of the shareholders in case the company suffers from the capital loss that exceeds half of its share capital[36] [The Second Directive is no longer in force as it was substituted by the Directive 2017/1132 of 14 June 2017 relating to certain aspects of company law. The article 19, though, remained unchanged and is now the article 58].[37] Such a provision of the Directive is transposed into national legislation of the EU Member-states. A good example of that is the German legislation that provides in their Stock Corporation Act the following:

> *"If upon preparation of the annual balance sheet or an interim balance sheet it becomes apparent, or if in the exercise of proper judgement, it must be assumed that the company has incurred a loss equal to one half of the share capital, the management board shall promptly call a shareholders' meeting and advise the meeting thereof".*[38]

[36] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 45

[37] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law

[38] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 45

Germany is not an only one European country with such a legislative provision. Something similar is presented in the majority of the EU Member-states. As was mentioned earlier by the author, this particular implicit duty of company directors to convene a, so to say, take preventive steps in order to avoid insolvency is a controversial one. Should it be separated from the general duty of care? If it should be separated, would it then be safe to say that this is a general duty of company directors when the company is completely solvent or it is more of a new duty that appears only in the vicinity of insolvency? These questions are important if we want to achieve legal certainty and make the European Union more convergent from the standpoint of the legal framework for the duties of directors across the Union.

The difficult issue here is the situation that if we, for example, stay on the side that the above-mentioned obligation to convene general meeting of shareholders when the company loses half of its share capital is a separate, yet implicit, duty of company directors, then there is a necessity to decide whether it appears only in the vicinity of insolvency of the company or not. Needless to say that the decrease of the half of the share capital does not always mean that the particular company is in the stage of insolvency. The company may still pass the requirements of the balance sheet test and liquidity test – it may be still able to pay its due debts. This means that such a duty of companies' directors appears not only in the vicinity of insolvency but also can occur while the company's financial situation is sound. That leads to the uncertainty.

If, on the other hand, one says that this duty is of "general nature", meaning that it is a part of general duties of directors (from the company law perspective), then should we distinguish the obligation to convene a shareholder's meeting into a separate "duty"? Or it is rather a part of the well-recognized across the EU Member-states duty of care because care over a company implies that the company's directors should ensure the soundness of its financial situation. For now, there is no universal approach and answer to the questions mentioned above. Even within the EU different Member-states provide for the different implementation of the Second Directive[39] [which is no longer in force as it was substituted] and particularly its article 19 [now it is article 58 of the new Directive, but the text remained without any changes] into their national legislation.

For example, contrary to the German way of implementation of the Directive's obligation for companies' directors to convene a meeting upon decreasing of company's share capital, some other EU Member-states such as Estonia, Latvia, Lithuania, Sweden, France, Czech Republic,

[39] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 46

Hungary, Italy, Portugal, Cyprus, Belgium, Spain and Denmark[40] have decided to require directors to do more than that and not only to call a meeting of shareholders, but also decide on that meeting whether to recapitalise or liquidate the company's business. If a director fails to do that in a certainly prescribed time-period or immediately (Portugal provides for such definition), such a director can be held personally responsible for the liabilities of the company.[41]

As we can see, there is no unified approach among the EU Member-states on the implementation of the Directive's provision regarding the above-mentioned duty. The approach described in the previous paragraph clearly ties the duty of companies' directors to convene a shareholders' meeting in case of decrease of half of the shared capital with the necessity to recapitalize or liquidate the company. Therefore, the mentioned European jurisdictions treat such directors' obligations as those connected with the state of insolvency of a company. Such situation does not foster convergence between the EU Member-states and does not allow us to ascribe the obligation to convene a meeting of shareholders directly to one of the institutes of law: company law or insolvency law. This question is still to be elaborated by scholars in the future.

1.2 POSSIBLE CHANGES IN THE SCOPE AND/OR NATURE OF THE DIRECTORS' DUTIES IN THE VICINITY OF INSOLVENCY

1.2.1 The issue of the "zone of insolvency"

Before we move further to the examples of the possible changes to the duties of directors when the company is insolvent, it is also important to mention the problematic issue with the mere definition of the "zone of insolvency". The difficulty lies in the time-period itself. When does the precise moment of the insolvency of the company occur? Or, even more, if it is possible to claim that the duties of companies' directors change even before the factual insolvency of the company during the period of "the risk of insolvency to occur", how then to define that period? These are the questions that require answers.

There are several tests for the determination of the insolvency of the company exist – the balance sheet test and the liquidity test. These tests are adopted into the EU Member-states' national insolvency legislation and help us to define is the company is currently in the state of being insolvent (meaning that it is not able to cover its debts that are due or its liabilities exceed the assets at a certain ratio or percentage). The tests themselves are efficient for the job they have been designed. That being said, the above-mentioned tests fall short when it is time to evaluate

[40] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 46

[41] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 46

whether the threat of the insolvency is imminent or whether the company has entered into the "vicinity of insolvency".

The liquidity test and the balance sheet test are widely acknowledged legal concepts within the EU Member-states and reflected in the national legislation of various jurisdictions. For example, Austria, Germany, and Bulgaria provide for the company being insolvent when it is illiquid or over-indebted (the implementation of the two tests mentioned above).[42] In Belgium and Luxembourg, the approach is that the company is deemed to be in a state of insolvency if it ceased to pay debts.[43] These two tests do bring some extent of legal certainty as to when the period of the insolvency of the company begins, but it does not solve every problem connected with that. Even having in the country's national law a certain provision that insolvency entails illiquidity of the company (when the company is not able to pay its debts due) or balance sheet insolvency (when the amount of liabilities of the company exceeds its assets) leaves the non-regulated field regarding the problematic issue with establishment of what liabilities can be taken into account in cash flow insolvency and whether future liabilities are to be also considered or not. The same problem with the determination of what assets and liabilities of the company should be taken into account exists with balance sheet insolvency.[44]

1.2.2 The shift in the scope of the directors' duties

Now, as we dealt with the issues of the general duties of companies' directors when the company is solvent and with the peculiarities of the determination of what is the period of the insolvency of the company, it is time to pay closer attention to the possible changes of the duties as the company approaches insolvency. This subsection of the Master's Thesis is devoted to such amendments of the director's duties. As the approaches for the regulation of these specific duties of company directors vary from country to country and it is impossible for one author to conduct efficient research of all EU Member-states' national jurisdictions (especially taking into consideration the language barriers), the approach towards analysing the changes into the directors' duties in the vicinity of insolvency will be the analysis of the existing scholarly articles on the relevant topics. In addition to that, the author's personal inquiry was also conducted – through contacting via digital communication means (emails) various law firms within the EU.

[42] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 48

[43] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 48

[44] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 48

This allows the author to get the responses from practitioners in the field of national company and insolvency law of the European Union. Yet, it is important to emphasize that due to the fact that the author asked for answers to the inquiries to be provided only on the voluntary basis, only minority of the law firms approached answered the questionnaire.

Having the mechanism of addressing the issues of directors' duties and liability in case the company became insolvent, the European Union Member-states regulate that in a different manner. Most of the EU Member-states do provide for some changes in the scope and/or the nature of the companies' directors duties when the company is already insolvent or approaching that state.[45]

There are two main strategies that are prescribed in the EU Member-states' national legislation: the first one provides companies' directors with an obligation to file for the opening of the insolvency proceedings in a timely manner.[46] Other countries (these constitute a minority among the EU Member-states, mostly those who belong to the Common Law tradition) provide instead of the duty to file for insolvency proceedings commencement the liability for the so-called "wrongful trading"[47] or the duty to cease trading at a certain point of time if the further trading process can harm the creditors' interests.[48] Somewhere in between the two cracks lies the rule named as "recapitalize or liquidate" – the one that has been described earlier in the previous section of the Masters' Thesis and was called controversial. Approximately one third of all EU Member-states decided to not only to implement the provision that was laid down in the Second Directive (and was transmitted into the new Directive without any changes) verbatim, but also added to that the necessity for companies' directors to decide together with the shareholders on the general meeting on the question of the recapitalisation or liquidation of the company.[49] Thus, in those national legal systems where such an approach (stricter than it is laid down in the Directive) is adopted an additional duty for companies' directors emerges and it would be safe to state that for that part of the European Union there are not two but three main strategies on how the directors' duties change in the vicinity of insolvency.

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[45] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 48

[46] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), xiv

[47] Róbert Muzsalyi, "Directors' Liability: What Should Be the Minimum Degree of Harmonisation in the EU?", *Eurofenix, (2016)*, 5

[48] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), xiv

[49] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), xiv

1.2.2.1 The duty to file for the opening of the insolvency proceedings in a timely manner

As it was mentioned before, the approach of having a duty to file for insolvency proceedings opening is a choice of most European jurisdictions. The time-periods for that requirements are, however different. This time varies from the moment in time that is defined as "immediately" under the Portuguese or Lithuanian national law (Latvia also does not provide in its legislation for a specified period of time to file for insolvency) and "without the undue delay" under the law of Czech Republic up to 60 days in Austria. The average term across the European Union, though, is 30 days. This is the most common choice across the European Union (if we talk about the EU Member-states where such obligation to file for insolvency procedure commencement exist). Some Member States, Poland is an example, had a provision that the time to file for insolvency is 14 days, but starting from 2016 the new insolvency legislation has come into force and brought the extension of this period to 30 days.[50]

As it was described in the above sections of the Master's Thesis, the triggering event for the commencement of the calculation of the period for the filling for the opening of the insolvency proceedings is the fact that the company is insolvent (according to the liquidity test or balance sheet test). That being said, among some of the EU Member-states there another concept has also gained some degree of recognition – the concept of imminent insolvency. Those EU Member-states who apply this concept (like Germany, Finland or Sweden) provide that in the case of the insolvency being imminent, companies' directors are not obliged but rather empowered to file for the opening of the insolvency proceedings.[51]

As we can see, the duty to file for the commencement of the insolvency proceedings in the EU Member-states that provide for such directors' obligation is closely connected with those "triggering moments" described above. The German experience is representative in this regard as their national law on directors' duties and companies' insolvency is very precise and can serve as a template for other national legal systems.

German insolvency law operates with the notion of so-called "twilight period" during which directors of companies should act twice as diligent as usually as the obligation to file for the opening of the insolvency proceedings may occur. According to German Insolvency legislation, a debtor (meaning the company in respect of its creditors) is considered to be illiquid if it is impossible for such company to cover its debts as they fall due. Such illiquidity is presumed

[50] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 48

[51] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 52

to occur when the company has ceased to make payments on their due debts (a classic example of the liquidity or cash flow test).[52] The German Federal Court has established several signs that serve as an evidence that the company failed to pass the liquidity test:

- a declaration made by the director of a company of the inability to honor future obligations;
- the closing of the business;
- execution of claims against the company;
- the mere non-payment of significant operating costs (such as wage-related costs).[53]

The rule described above, however, contains an exception that if the illiquidity of the company is not significant (inability to pay debts that is less than 10% of the aggregate liabilities of the company for the period of three weeks), than there are worries for the company's directors unless it is obvious that the situation may become worse.[54]

Apart from the notion of illiquidity of the company as a ground for the application by the company's directors for the opening of the insolvency proceedings, current German legislation is also operating with the term "imminent illiquidity". According to the section 18 of the German Insolvency Code [Insolvenzordnung – InsO], the state of imminent illiquidity of the company occurs when:

> *"... if [the debtor]* ***is likely to be unable*** *to meet existing payment obligations when they fall due."* [emphasis added]

So, as we can see, the difference between the "usual" illiquidity and imminent illiquidity lies in the subjective and objective approach. The evidence for the illiquidity is objective – the fact that the company has stopped making payments to its creditors as its debts fall due, whereas the imminence of the illiquidity is always subjective, meaning that it can only be obvious or not to the perception of the company's directors whether the company will be able to cover its due debts or not.

The necessity of implementation of such a subjective criterion to one of the tests of the company's financial soundness stems from the desire to facilitate corporate restructuring in the country and previous experience with the former German Bankruptcy Code under which it was difficult for the company to conduct restructuring of its business because of the actions from the company's creditors who frequently interfered into the plans of company's management with claims for seizure of the assets of the estate required to maintain and continue with the business.

[52] "Germany" n.d. In *Directors in the Twilight Zone V.*, 2.
[53] "Germany" n.d. In *Directors in the Twilight Zone V.*, 2.
[54] "Germany" n.d. In *Directors in the Twilight Zone V.*, 2.

With the implementation into the Insolvency Law the criterion of the imminent insolvency, it has become easier for the companies' directors to choose, as one of the possible options, to apply for the commencement of the insolvency proceedings in advance – on the basis of the company's imminent insolvency and to opt the initiation of the reorganisation measures, in particular the implementation of a pre-packaged reorganisation plan at an early stage of insolvency proceedings.[55]

Under German insolvency and company legislation, there is also a place for the recognition of the notion of "over-indebtedness" of the company that occurs when the company fails to pass another classic test – the balance sheet one. The over-indebtedness of a company is considered to be a ground for the director's application for the commencement of the insolvency proceedings.

According to the German Insolvency Code, more precisely its section 19, the state of over-indebtedness of a company occurs when:

> *"… debtor's assets no longer cover its existing liabilities, unless the continued operation of the enterprise is substantially likely in the circumstances".*[56]

The "twilight" period that was described above, during which the companies' directors are to be under higher scrutiny while managing day-to-day business operations and should be very careful as they may be subsequently held personally liable for any harm caused to the company and/or its stockholders, ends with either the improvement of the company's financial profile or the commencement of the insolvency proceedings. In case of the materialization of the latter scenario, the directors' right to manage the company's activity and deal with its assets will pass to the insolvency practitioner. The directors remain to be registered with the commercial register, but their decision-making power within the company ceases. Thus, the directors can no longer be held liable for a breach of obligations aimed at the protection of creditors but still should cooperate with the insolvency practitioner and hide no information on the peculiarities of the financial situation of the company from the insolvency administrator.[57]

As we can see, Germany provides a very detailed and clear legislative framework in respect of the duties of the companies' directors, criterions of the insolvency of the company. This allows directors to foresee the possible changes in the scope of their obligations in case of the deterioration of the financial situation of the companies they manage and to plan the line of actions that they want to perform in order to avoid personal liability towards the company, its shareholders, creditors and other stakeholders.

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[55] "Germany" n.d. In *Directors in the Twilight Zone V*., 2.
[56] *German Insolvency Statute (Insolvenzordnung)*, section 19, para.2
[57] "Germany" n.d. In *Directors in the Twilight Zone V*., 2.

Another prominent example of the European jurisdiction that provides for the additional duties for the companies' directors when the company faces insolvency is Slovenia. It is worth mentioning that as the author of the current Master's Thesis is by no means specialist in the various national peculiarities of the insolvency law in various EU Member-states as well as a person with no knowledge of Slovenian language, the information on the existing national legal provisions in the sphere of insolvency and company law was provided as a reply for the author's inquiry by several law firms operating in Slovenia and familiar with the national legislation in force.

As regards the problematic point on the definition of insolvency and its influence on the possible changes of the scope and nature of the duties of the companies' directors, the answers are to be found in the "Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act" No 126/2007 [*In Slovenian - Zakon o finančnem poslovanju, postopkih zaradi insolventnosti in prisilnem prenehanju*]. According to the Article 14 of the Act, the situation of the company's insolvency occurs when:

- the company is permanently illiquid (a state of a continuous insolvency), meaning that the company is for a longer time period incapable of settling all its obligations and debts that fall due. It is a classic example of the liquidity test with the subjective criterion of a longer period of time. The company is not deemed to be insolvent if it is not able to pay its debts due for an only short period of time.
- OR, as a result of the long-term payment incapacity, meaning that the company does not have a sufficient portfolio of long-term financial resources with respect to the type and scope of business transactions it performs (an example of the balance sheet test).[58]

The Slovenian law on insolvency matters also recognizes several rebuttable presumptions as to when the company is deemed to be in a state of insolvency and one irrebuttable presumption on permanent illiquidity. The only situation when it is impossible according to the law to rebut the presumption of the company being insolvent is considered to be when such company is for longer than three months in default with the payment of salaries of employees up to the amount of salary equal to the amount of minimal salary or with the payment of taxes and social security contributions that have to be paid with the payment of salaries, except if the payment of taxes and social security contributions was delayed in accordance with the law on tax procedure.[59]

As we can see, Slovenia applies quite similar rules as regards the determination of the precise moment starting from which it is possible to consider the company being in a state of

[58] *Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act*, No 126/2007
[59] "Insolvency Proceedings in Slovenia." n.d. Rojs, Peljhan, Prelesnik and partnerji. Memorandum of law

insolvency as the rules established in Germany that we described above. However, Slovenian approach towards the duties of directors in the position when the company is insolvent is interesting for our research as it represents an interesting change in the scope of such duties.

First of all, the Slovenian Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act provides for the specific duties of the companies' directors that are aimed towards the creditors' interests when the company is insolvent:

- the duty of equal treatment of all creditors;
- the duty to analyze what precisely caused the company to become insolvent and to adopt the measures that would be appropriate for saving such company.[60]

The duty of the companies' directors to treat creditors of the company equally is formulated of two general restrictions. The first one is about the prohibition for the company to perform payments or take over some new obligations in addition to those that are necessary and essential for the regular business operation of the company. The second restriction requires companies' directors refrain from acting any way that would put one creditor who are in an equal position in relation to the company into an unequal position towards the other creditors. This does not mean that all creditors should be equalized (like those who have secured claims with those how does not) but is all about the prohibition for company's directors buy any actions or decisions to create inequality among the previously equal creditors.

As regards the examples of payments that are essential for the functioning of the company, the non-exhaustive list of such is laid down in the Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act and consists of the following:

- payment necessary for the regular operation of the company (for electricity, water supply etc.);
- claims of creditors against the company who has the so-called "preferential claims" – employees' salaries, taxes, social security contributions etc.);
- current supplies of goods and services required for the functioning of the regular business of the company, etc.[61]

As we can see, Slovenia opted for the approach that is sort of different from the one adopted by the other EU Member-states in respect of the additional duties of the companies' directors that arise only when the company is approaching insolvency - the explicit requirement for the directors

[60] *Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act*, No 126/2007
[61] *Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act*, No 126/2007

not to hamper the equality of the company's creditors who are in the equal position in relation to the company.

In order to provide some guidance for the directors of what actions constitute such inequality, the Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act provides for the examples that include (the list is also non-exhaustive):

- any action that causes the redirection of financial flows or other operations of the company to other legal or natural persons;
- adoption of any legal acts on behalf of the company that may be challenged in bankruptcy proceedings (for example, provision of more favourable conditions for repayment of debts in respect of one or several creditors that is harmful for the interests of the others; reduction of the net value of the company's assets that may result in lower repayment for creditors etc.).[62]

Another interesting provision under the Slovenian insolvency legislation that is also not common for other European jurisdiction in respect of the duties of companies' directors in the vicinity of insolvency is the existence of the directors' duty to analyze causes for insolvency and adopt appropriate measures. One may contradict that such a duty, as well as the previously described one, is also present in other jurisdictions across the European Union as a part of the general duty of care. Indeed, companies' directors in all EU Member-states do have the duty to act diligently and make wise decisions while running the day-to-day business of the company, thus, it would be safe to assume that the general standard of care covers also the necessity for the companies' directors to analyse the possible causes of the unstable financial situation that is happened to their companies. This opinion is definitely viable. That being said, the approach of the Slovenian legislator was to set an express provision, not an implied one, that refers specifically to the situation when the company is insolvent or is in the vicinity insolvency. Contrary to the standard duty of care that exists for the companies' directors during every single moment when they are managing the company, the duty to conduct the analysis of the causes of insolvency appears when the financial situation of the company deteriorates and, contrary to the approach of other European jurisdictions (where companies' directors are required either not to conduct the "wrongful trading" or to convene a general meeting of the company's shareholders and, subsequently, to file for the opening of the insolvency proceedings if the situation dictates that way of behaviour) Slovenian insolvency legislation provides for the directors' duty to conduct an

[62] *Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act*, No 126/2007

analysis and to present it to the company's shareholders. Such approach exists and, in the author's point of view, deserves to be described in the current Master's Thesis in more details.

The scope of the duty to analyse the causes of insolvency of the company and adopt appropriate measures is the following: if the company's director or the management board establishes that the company suffers from financial difficulties and this may lead or has already led to the situation of insolvency of such company, the directors are required to conduct an analysis and to prepare a report on the causes of the insolvency and the measures that is possible to adopt to combat the company's financial problems within one month starting from the moment when the situation at hand occurs. Such report has to include the description of the financial situation of the company at the current moment (the moment when the report is drafted), analysis of the causes of for insolvency and company's directors' opinion on the possibility of at last 50% chance that the financial restructuring of the company could be successful.[63]

If the opinion on the possible recovery of the company (at least 50% chance) is rather negative, the company's directors are obliged to initiate bankruptcy proceedings. If after the analysis conducted by the company's directors it was found out that the company is in the state of insolvency, then, depending on the estimated by the management chance of possible recovery of the company (more or less than 50% chance), the company's directors should take one of the following measures:

- initiate the procedure for the financial restructuring of the company (outside of insolvency proceedings);
- initiate compulsory settlement proceedings;
- file for the opening of the bankruptcy proceedings.[64]

As we can see, under the Slovenian legislation in force the companies' directors are obliged to take an active involvement in the company's life even after the situation when the state of insolvency of such company was established. The directors in this case are not just obliged to convene a general meeting of shareholders and pass all the responsibility for the future perspectives of the company directly to its shareholders or obliged to decrease the volume of the company's business transactions and pay close attention to the content and purpose of such transactions in order to ensure that they are outside of the field of the "wrongful" or "fraudulent" trading. They are deeply involved in the process of finding the solution on how to bring things to normal state and to escape winding up of the company.

[63] *Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act*, No 126/2007
[64] *Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act*, No 126/2007

1.2.2.2 The prohibition of engaging in "wrongful trading"

The duties of companies' directors that have been described in brief in previous sections like the duty to file for the opening of the insolvency proceedings, the duty to convene a meeting of shareholders or the duty to conducts an analysis of the causes of insolvency are typical for the EU Member-states whose legislative technique has its roots in the Roman Law tradition – these are commonly referred to as Civil Law countries. Those countries who can trace their origins of legislative technique in Anglo-Saxon or Anglo-American law and are commonly referred as countries of Common Law tradition provide for some different approach towards the regulation of such legal institute as duties of companies' directors in the vicinity of insolvency. Of course, countries such as the United Kingdom also have this duty to act in best interests of the creditors, act diligently etc., but in addition to that, they have some other peculiarities that distinguish such countries among others.

Describing such thing as "wrongful trading" prohibition can be a controversial task as there is a certain degree of uncertainty from the theoretical standpoint as to what institute of law it is possible to attribute this issue. Civil Law countries like, for example, Germany have a strict and precise rule – to perform a trading activity within a company while being insolvent is prohibited. In case company's director decides to violate that prohibition, he or she will suffer punishment – will be held liable for that. Other EU Member-states allow trading while being insolvent but only to a certain extent – if the director crosses the line where it is possible to say that the trading activity of the company was "wrongful" or even "fraudulent" – the punishment will follow immediately and the company's director will face legal consequences. So, one could possibly say that the prohibition to trade while insolvent of the "wrongful trading" concept is a part of the institute of corporate liability of the companies' directors. At the same time, if we go from the opposite side and say that the duties of companies' directors may materialize not only into some form of active performance but also can be described as duties to refrain from certain actions, then it would be possible to state that the "wrongful trading" prohibition is rather a form of director's duty not to engage in certain activity for the benefit of the company and its stakeholders. Thus, for the sake of completeness of the current Master's Thesis the "wrongful trading" strategy will also be covered in the current section of the duties of companies' directors in the vicinity of insolvency.

As it was mentioned before, those EU Member-states that apply the rule of prohibition to trade while being in a state of insolvency does not allow companies' directors to engage in any trading activity after the company crossed the "red line" of insolvency except for the performance of the contracts and business activity that is vital for the existence of the company like the contracts on the electricity and water supply. Those European jurisdictions that apply the strategy of wrongful trading allow directors of companies to "trade themselves out of insolvency", meaning

that up to a certain period of time to continue trading while being in a state of "balance sheet insolvency". Yet, it is important to notice that the wrongful trading remedy may also be triggered while the company is still solvent. That is possible if directors of a formally solvent company plan to enter into some dubious transaction that may bring the company into the state of insolvency with a situation when it will be unlikely to recover after that. In this case, such activity will be recognized as being wrongful.[65]

The "wrongful trading" concept is widely applied in the EU Member-states like the United Kingdom (provisions laid down in the UK's Insolvency Act 1986, section 214), Malta (Companies Act 1995, art. 316); similar to wrongful "reckless trading" in Ireland (Irish Companies Act 2014, section 610) and some other countries.[66] The quite similar concept is also present in Hungary. Hungarian insolvency law that is in force does not provide for the companies' directors' duty to file for the opening of the insolvency proceedings if there is only a situation of "threatening insolvency" which is not yet materialized. Under the Hungarian law, the company's director in a situation of the threat of insolvency for his or her company should act (possibly through trading) in order to improve the situation. While performing those actions the due consideration must be given first and foremost to the company's creditors.[67] Thus the companies' directors in Hungary, actually, encouraged to take active actions and try to dig their near-insolvent companies out of financial turbulence.

Speaking about the United Kingdom as the jurisdiction with the most comprehensive set of rules in relation to the concept of wrongful trading, it is worth noting that the provisions on this concept were codified in the UK's Insolvency Act of 1986 and prior to that period the companies' directors could face legal consequences only for the violation of the rules of fraudulent trading – a legal concept that should be distinguished from the wrongful trading.[68]

The wrongful trading strategy applies both to companies' directors and to the "shadow directors". As the wrongful trading is a concept that is applicable towards the directors at a stage when the company is already insolvent or functions in the vicinity of insolvency, the judge that will subsequently be assessing the behavior of the company's director should apply some criterions of such assessment. That is why the objective and subjective standards were elaborated by scholars

[65] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), xiv

[66] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 53

[67] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 53

[68] "England and Wales" n.d. In *Directors in the Twilight Zone V.,* 4

and practitioners to ensure the just legal procedure regarding the assessment of the companies' directors trading incentives.[69]

Both of the criterions are laid down in section 214 of the Insolvency Act 1986 and provides for the following:

> *"For the purposes of subsections (2) and (3) [of the section 214], the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken,* ***by a reasonably diligent person*** *having both—*
>
> *(a)the* ***general knowledge, skill and experience*** *that may reasonably be expected of a* ***person carrying out the same functions*** *as are carried out by that director in relation to the company, and*
>
> *(b)the general knowledge, skill and experience* ***that that director has****". [emphasis added].*[70]

As we can see, the objective criterion requires the court to analyse the actions of the company's director from the standpoint of the knowledge and skills that a reasonable person of the same kind possesses (objective criterion) as well as the experience and theoretical and practical background of the particular director (subjective criterion), meaning that if a director has some level of expertise in the companies' management and certain specific skills and knowledge in respect of the business transactions that he or she conducted or business decisions that have been made by such director, those skills should be used taking into consideration the interests of the company and its creditors.

The concept of "wrongful trading" should be distinguished from the "fraudulent trading" which is about the completely different situation. The section 213 of the Insolvency Act 1986 provides for the following in respect of the fraudulent trading:

> *"If in the course of the winding up of a company it appears that any business of the company has been carried on with* ***intent to defraud creditors*** *of the company or creditors of any other person, or for any* ***fraudulent purpose****, the following has an effect.*
>
> *The court, on the application of the liquidator, may declare that any persons who were* ***knowingly parties*** *to the carrying on of the business in the manner above-mentioned are to be* ***liable to make such contributions*** *(if any) to the company's assets as the court thinks proper".*[71] [emphasis added]

[69] "England and Wales" n.d. In *Directors in the Twilight Zone V*., 4
[70] *Insolvency Act 1986,* section 214
[71] *Insolvency Act 1986,* section 213

The above mentioned means that even though the company's creditors may act using all their knowledge and level of expertise in respect of certain company's business transaction but while doing so had the intent to either deliberately decrease the bunch of the company's assets or to harm the creditors' interests in any other way, such actions will be recognized as fraudulent with the corresponding consequences. If we look back at the general duties of companies' directors when the company is completely solvent – the duty of loyalty and duty of care, the situation with wrongful trading and fraudulent trading, to the author's opinion, resembles the stringent standard of the duty of care and loyalty. As we already know, when the company approaches insolvency, the degree of directors' care and attention increases. They should think twice as careful as in usual circumstances paying special attention to the interests of company's creditors. It is possible to find the similarity between the duty of loyalty and the concept of fraudulent trading – they both are about not to cheat, not to betray the interests of the company and its stakeholders in the first situation (the duty of loyalty) and not to betray the interests of the company's creditors when we are speaking about the concept of fraudulent trading. The wrongful trading quite resembles the standard that is applicable towards the duty of care – they are both about using all the skills and knowledge that directors have for the benefit of the company and its stakeholders (in a situation of the duty of care) and to the benefit of, mostly, the interests of creditors when the company is in the zone of insolvency. This is an additional proof that the concepts of wrongful and fraudulent trading can be ascribed to the legal institute of the duties of directors – these concepts are similar to the general duties of companies' directors, it is the finite beneficiary who changes (the company and its stakeholders in case of the general duties of directors and, mainly, creditors in case we are talking about the wrongful and fraudulent trading concepts).

1.3. CONCLUSIONS TO THE GENERAL OVERVIEW OF THE DIRECTORS' DUTIES

In the general part of the current Master's Thesis, the author analyzed the approach and experience of various European Union Member States in respect of the duties of companies' directors. At the very beginning, the enumeration and a brief description of the two widely spread duties of companies' directors was given – the duty of loyalty and duty of care. As we could see, those two duties are part of corporate legislation in every EU Member-state and there are little to no differences in the standards of application of the above-mentioned duties. Further in the Thesis certain differences among the EU Member-states as regards the possible changes to the general duties of companies' directors were enumerated. The analysis showed that there are several big groups of the European jurisdictions' approach towards the regulation of the directors' duties in the vicinity of insolvency can be distinguished: the EU Member-states who follow the approach of the existence of the additional duty for the companies' directors – the duty to file for the

commencement of the insolvency proceedings in case the directors see that the company is failing the liquidity test and/or balance sheet test or when it becomes obvious that the state of insolvency is imminent. In these countries, it is usually prohibited for the company's directors to conduct trading activity when the company is insolvent (the example of Germany was described). The second big group of the EU Member-states stands on the position that it is better to allow the company's directors to trade while being insolvent in order to let the company's management to "trade the company out of financial troubles". Such countries tend to use the approach of the "wrongful trading" concept that provides for the punishment for the company's directors only when their trading activity has led to the deterioration of the company's assets that is harmful to the interests of its creditors (the example of the United Kingdom was described). In addition to that, the author raised the question of the legal nature of such legal concepts as "wrongful" and "fraudulent" trading and has expressed his opinion on that matter. Finally, the third group of states was also mentioned – those who do not provide in their national legislation for any changes to the scope and/or nature of the duties of companies' directors.

Thus, as it was established, that at least some of the EU Member-states do provide for the changes to the duties of the companies' directors in the vicinity of insolvency, the further analysis will be done in the field of the main problematic of the current Master's Thesis – the existence or non-existence of the practical obstacles towards the effective application of the directors' duties in cases with cross-border element. In the special part of the Thesis, we will analyze in more details the sources of the legal provisions that regulate the duties of companies' directors, more precisely – in what legal acts do such provisions laid down or under which "umbrella" they exist – the company law or insolvency law. In case the analysis shows that part of the legal provisions in respect of the duties of the companies' directors are located in the bunch of company law provisions and the other part is laid down under the "umbrella" of the national insolvency law provisions, we then will analyse the peculiarities of the application of such provisions by the courts when there is a cross-border element present.

2. THE PROBLEM OF THE LEGAL UNCERTAINTY IN RESPECT OF THE APPLICABLE LAW ON THE DIRECTORS' DUTIES IN CASES WITH A CROSS-BORDER ELEMENT

The special part of the current Master's Thesis will be devoted to the precise problem that was outlined in the Thesis's introductory part – the issue of obstacles that exist on practice when we are talking about the cases of disputes involving duties of companies' directors and have a cross-border element, more precise – the application of the national substantive law provisions on companies' directors' duties when there is a dispute that involves a cross-border element.

The closer attention will be paid to the analysis of the existing codification of the duties of companies' directors within the national legal systems of the European Union Member States. As we saw from the analysis that was conducted in the general part of the Master's Thesis, the EU Member-states tend to apply different approaches towards the amendments in respect of the scope and nature of the duties of the companies' directors as the company moving into the vicinity of insolvency – some of them provide in their national legislation for the appearance of the additional duties for the companies' directors when the financial situation of the company is getting worse. That is why in the special part of the Master's Thesis we will have a look at whether the duties of companies' directors that exist when the company is financially sound and the duties that materialize as the company is entering the zone of insolvency are located in different "fields" of the national legislation, for example, company law and insolvency law, or tort law etc. If subsequently it is found that for those European jurisdictions that do provide for the modifications or additions to the scope and/or nature of the duties of companies' directors it is accurate to say that such different duties are covered by different "umbrellas" of the law (some under the scope of insolvency law and some are under the scope of company law, for example), then the next step will be the analysis of whether this situation may lead the court, when hearing some particular case with cross-border element involved, to the issues of legal uncertainty of what substantive national law provisions to apply in respect of the duties of companies' directors. We will then look at the existing courts' practice to find out whether such issue has been raised previously and if yes, what were the responses to the problem at hand.

The most detailed attention in the course of the current Master's Thesis's analysis will be devoted to the existing practice of the Court of Justice of the European Union, the Recast of the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings as to whether the answers to the existing practical hurdles in respect of the duties of companies' directors can be found there and also as to whether such answers, if any, solve the problem and bring enough clarity and elimination of the legal uncertainty to this field.

In the course of the Thesis's author's analysis of the problematic issue at hand, an additional reference will be made to the Treaty on Functioning of the European Union, specifically towards the articles that deal with the freedom of establishment. As one of the goals of the current Master's Thesis is to identify the particular issues that exist in the sphere of the law governing duties of companies' directors in the vicinity of insolvency that might hamper the existing level of convergence between the EU Member-states and lead to the legal uncertainty with the possible consequence of the discouragement of the companies' directors to move their business in the other European jurisdictions, the due regard to the issue of the freedom of establishment should be also given. In the opinion of the author of the current Master's Thesis, the convergence of the European Union is beneficial for its Member States, and if the legal uncertainty in respect of the duties of the companies' directors, that may exist within the national legislation of the EU Member-states, may lead to the situation when the company's directors are discouraged from moving the centre of main interests of their business into other European jurisdictions and, as a consequence, such situation is hampering the due functioning of the promoted by the European Union freedom of establishment, such legal uncertainty should be reduced to the possible minimum if not eliminated.

2.1 LEGISLATIVE FRAMEWORK AND SOURCES OF THE DIRECTORS' DUTIES UNDER THE NATIONAL LEGISLATION OF THE EU MEMBER-STATES. A COMPARATIVE ANALYSIS.

In this section of the Master's Thesis, we will pay close attention towards the existing legal framework in the European Union Member-states in respect of the regulation of the duties of companies' directors. The primary aim of this section is to identify whether those countries who do provide through their national legislation certain changes in respect of the scope or/and nature of the directors' duties when the company is approaching or already in the state of insolvency, tend to codify such duties in different bunches of the national legislation. In particular, we are looking for the proof that the European Union Member-states regulate the duties of companies' directors under different "umbrellas": insolvency law, company law, tort law, a general bunch of civil law or corporate law etc.

2.1.1 The United Kingdom

The problematic issue with the European Union Member-states that find their roots in the Anglo-Saxon legal tradition (usually referred as Common Law countries) and the United Kingdom, in particular, is the fact that such countries tend not to codify some of the rules in respect of the functioning of the companies, and in particular regarding the duties of companies' directors, but rather rely on the existing practice of their national courts. That being said, it is still possible to identify some obligations for the directors of companies in the codified legislation.

In the UK the bunch of codified legislation that can be referred to as company law consists mainly of the Companies Act 2006, UK's Corporate Governance Code, the Takeover Code and the Listing Rules.[72] Among the piece of insolvency-related codified legislation in the United Kingdom, the most well-known one if the Insolvency Act 1986.

For the purposes of the current Master's Thesis, we will concentrate on the analysis of the national framework of regulation of the duties of companies' directors that is codified i.e. is provided in the existing UK's legislation that is in force and will pay less attention to the practice of the UK's national courts.

The first thing to mention in this regard is that United Kingdom's approach towards the relations of the companies' directors and its stakeholders is rather shareholder-centric (*notwithstanding the fact that according to the codified legislation in force – the Companies Acts 2006 – the directors' duties are owed to the company itself*)[73]. In one of the sections of the general part of the Thesis, we paid closer attention towards the issue of the addressees of the companies' directors' duties both when the company's financial situation is sound and in the situation when the company approaches the vicinity or is already in the state of insolvency. The conclusion on the existence of the general trend of the "shift" in respect of the addressees of the directors' duties among the EU Member-states was reached. It was stated by the author of the Thesis that most of the EU Member-states are shareholder-centric in respect of the directors' duties when the company is completely solvent The same can be extrapolated to the example of the UK. The shareholder-centric approach can be traced from the principles that are laid down in the UK's Corporate Governance Code. Here it is important to mention that the Corporate Governance Code is not a classic codified set of legally binding rules, but rather a set of principles of good corporate governance that is applicable towards the management board of the companies listed on the London Stock Exchange[74], but it is quite representative from the standpoint of the general directions that the companies' directors should follow exercising their duties while managing the day-to-day business operations of the company. According to the principles laid down there, the companies' directors should manage the company's business for the benefit of its shareholders and ensure the existence of the effective dialogue between the board and the shareholders.[75] In the vicinity of insolvency, however, and it is codified in the Companies Act 2006, the shift towards the interests of company's directors occurs. Section 172 in its paragraph 3 provides as follows:

[72] Carsten Gerner-Beuerle, Philipp Paech, and Edmund Philipp Schuster. "Annex to Study on Directors' Duties and Liability." (2013), A 869
[73] *Companies Act 2006*, section 170
[74] "UK Corporate Governance Code." n.d. *Wikipedia*
[75] "Corporate Governance Code." 2014. Financial Reporting Council (2014), Section E

"The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or ***act in the interests of creditors of the company****"*[emphasis added].[76]

The primary evidence that the main duties of companies' directors are codified under the "umbrella" of the company law of the United Kingdom is, of course, the Companies Act 2006. The Act devotes the whole Chapter 2 which contains several sections towards the main duties of companies' directors when the company is solvent. Section 170 of the Companies Act 2006 provides for the following:

"Scope and nature of general duties

(1) The general duties specified ***in sections 171 to 177*** *are* ***owed by a director of a company to the company****.*

(2) A person who ceases to be a director continues to be subject—

(a)to the duty in section 175 (duty to ***avoid conflicts of interest****) as regards the exploitation of any property, information or opportunity of which he became aware at a time when he was a director, and*

(b)to the duty in section 176 (duty ***not to accept benefits from third parties****) as regards things done or omitted by him before he ceased to be a director. ...*

(3) The ***general duties*** *are* ***based on certain common law rules*** *and equitable principles as they apply in relation to directors and have effect in place of those rules and principles as regards the duties owed to a company by a director.*

...

(5) The general duties ***apply to a shadow director*** *of a company where and to the extent that they are capable of so applying".*[emphasis added][77]

In total, the sections 171 to 177 of the Companies Act 2006 provide for the existence of seven general duties of companies' directors: duty to act within powers; duty to promote the success of the company; duty to exercise independent judgement; duty to avoid conflicts of interest [duty of loyalty]; duty of care, skill and diligence; duty not to accept benefits from third parties and duty to declare interest in proposed transaction or arrangement.[78]

Now it is time to move to the UK's insolvency legislation in force and to identify whether it provides for the additional duties of companies' directors in the vicinity of insolvency. The Insolvency Act 1986 under its section 214 provides for the following:

"...

[76] *Companies Act 2006*, section 172, paragraph 3
[77] *Companies Act 2006*, section 170
[78] *Companies Act 2006*, Chapter 2, sections 171 to 177

This subsection [concerning the prohibition of conducting wrongful trading] *applies in relation to a person if—*

(a)the company has ***gone into insolvent*** *liquidation,*

(b)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, and*

(c)that person ***was a director of the company at that time*** [emphasis added]*;*

…"[79]

In addition to the wrongful trading prohibition, another duty of directors when the company goes insolvent is located in the neighboring section 213 of the Insolvency Act 1986 – the duty to avoid conducting the fraudulent trading.[80]

As we could see from the provisions of the current national legislation in force, the United Kingdom does provide for the legal regulation in respect of the duties of companies' directors to be located in different sets of rules, apart from the regulative framework that comes from the existing courts' practice of course, - insolvency laws and company laws.

2.1.2 Germany

Another one European jurisdiction that is sort of exponential for the current Thesis's analysis is the German one. Some other EU Member-states' jurisdictions took German approach towards the regulation of the social relations that occur between various participating actors in respect of the functioning of the corporate entities and insolvency relations. Apart from that, Germany is a typical country with the roots in Romano-Germanic legislative tradition, that is why their experience with the regulation of the duties of companies' directors may be representative.

What is even more important, is the situation which relates closely to the main object of the current Master's Thesis research problem – the practical hurdles that may arise in connection to the issue of applicable substantive law in cases which include a cross-border element. One of the landmark cases that was raised before the Court of Justice of the European Union in connection to the problem that is a key element of the current Master's Thesis – "*Kornhaas v Dithmar case*" came directly from Germany. That is why the German approach towards the normative consolidation of the duties of companies' directors is very important for our research.

An additional advantage is the fact that the main company acts of Germany are well translated into English language, so there is no necessity to conduct author's translation of the authentic text in the original language.

[79] *Insolvency Act 1986,* section 214
[80] *Insolvency Act 1986,* section 213

The main legal sources of the duties of the companies' directors are, in our case, German AktG [Aktiengesetz – German Stock Corporation Act][81] if we are talking about the duties of directors holding their positions in public limited companies and GmbH [Gesetz betreffend die Gesellschaften mit beschränkter Haftung – German Limited Liability Companies Act][82] if we are talking about the duties of directors who hold their positions in limited liability type of companies.

Within the German Stock Corporation Act, the most interesting provisions for us laid down in section 93 of the Act according to which:

> *"**Duty of Care** and Responsibility of Members of the Management Board*
>
> *(1) In conducting business, the members of the management board **shall employ the care of a diligent and conscientious manager**. 2 They shall not be deemed to have violated the aforementioned duty if, at the time of taking the entrepreneurial decision, they had **good reason to assume** that they were **acting on the basis of adequate information** for the benefit of the company. 3 They **shall not disclose confidential information** and secrets of the company, in particular trade and business secrets, which have become known to the members of the management board as a result of their service on the management board"* [emphasis added].[83]

As we can see from the provisions of paragraph 1 of section 93 of the German Stock Corporation Act, it provides for the legal framework of the directors' duties of care and part of the duty broad scope of the duty of loyalty, more precisely – the duty to refrain from the disclosure of the confidential information that the companies' directors acquire in the process of management of the day-to-day business operations of the company.

In addition to the above-mentioned provisions, some other duties of public companies' directors can also be found under the scope of the German Stock Corporation Act like the duty to refrain from the competition with the company where the director holds its position (section 83(2)); the duty to call for a special meeting of shareholders in case of loss of half of the share capital (section 92 that is, if fact, and embodiment of the provisions of the Directive 2017/1132 of 14 June 2017 relating to certain aspects of company law that we have already mentioned in the general part of the current Master's Thesis) etc.[84]

Speaking of German limited liability companies' directors and their duties, it is necessary to analyze the provisions of the German Limited Liability Companies Act. The key provisions for

[81] *German Stock Corporation Act (Aktiengesetz)*
[82] *German Stock Corporation Act (Aktiengesetz)*
[83] *German Stock Corporation Act (Aktiengesetz)*, section 93, paragraph 1
[84] Carsten Gerner-Beuerle, Philipp Paech, and Edmund Philipp Schuster. "Annex to Study on Directors' Duties and Liability." (2013), A 330

our research purposes can be found under the sections 35 and 37 of the German Limited Liability Companies Act. Section 35 provides for the following:

"Representation of the company

(1) The company shall ***be represented in and out of court by the directors****. If a company has no director, the company shall be represented by the shareholders whenever declarations of intent are made or documents are served on it.*

(2) If ***several directors have been appointed****, they shall only all be* ***jointly authorized to represent the company****, unless provided otherwise in the articles of association"* [emphasis added].[85]

Paragraph 1 of Section 37 sets the following rules:

"Restrictions on the power of representation

(1) The ***directors shall be obligated vis-à-vis the company*** *to* ***observe those restrictions*** *which have been set out* ***in the articles of association*** *as regards the* ***extent of their power to represent the company*** *or, unless otherwise provided therein, by resolutions passed by the shareholders"* [emphasis added].[86]

The examples of the provisions from the German Limited Liability Companies Act cited above show us among the main duties of the companies' directors to be the duty to represent the company staying in the boundaries and restrictions provided by the company's articles of association. Broadly, the directors of German limited liability companies have the same scope of the duties to obey as those of the public companies[87] and, as we can see from the above examples, such duties are located under the "umbrella" of the company legislation.

As regards the duties of the companies' directors when the company is approaching insolvency, there is an interesting situation under German law. First of all, we will refer to the German Insolvenzordnung [Insolvency Statute or also commonly referred as German InsO]

Paragraph 1 of the section 15a of the Insolvenzordnung provides for the following:

*"****Obligation to Request*** *in the Case of Legal Persons and Associations Without Legal Personality*

(1) Where a legal person becomes ***illiquid or overindebted****, the members of the* ***board of directors*** *or the liquidators* ***shall file a request for the opening of proceedings without culpable delay****, at the latest, however, three weeks after the commencement of*

[85] *German Limited Liability Companies Act (Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG)*, section 35

[86] *German Limited Liability Companies Act (Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG)*, section 37

[87] Carsten Gerner-Beuerle, Philipp Paech, and Edmund Philipp Schuster. "Annex to Study on Directors' Duties and Liability." (2013), A 331

insolvency or overindebtedness. The same shall apply to the organ representatives of the partners authorized to represent the company or the liquidators in the case of a company without legal personality where none of the general partners is a natural person; this shall not apply if one of the general partners is another company in which a general partner is a natural person" [emphasis added].[88]

This provision cited above is the most notable change that occurs in respect of the duties of companies' directors as the company moves into the vicinity of insolvency. A provision similar to this one can be found under the national legislation of several other EU Member-states.

The situation with the duties of companies' directors in the vicinity of insolvency was called by the author of the Thesis as an interesting one, because apart from the German insolvency legislation, some provisions on the duties of companies' directors related to insolvency can be found also under the "umbrella" of the company law.

For example, the paragraph 2 of section 92 of the German Stock Corporation Act provides for the following rules:

*"**Duties of the Management** in the Event of Losses, Overindebtedness or **Insolvency***

*(2) **If the company becomes insolvent** or overindebted, the management board **may not make any payments**.*

*The foregoing **shall not apply to payments** made after this time that are nonetheless **compatible with the care of a diligent and conscientious manager**.*

*The **same obligation** shall apply to the managing board **for payments to shareholders** as far as such payments were bound **to lead to the stock corporation's insolvency** unless this was unforeseeable even when employing the care set out § 93 (1) sentence 1"* [emphasis added].[89]

As we can see from the provisions quoted above, the two important duties for companies' directors who manage the company that is near or already insolvent can be found there: the prohibition to conduct the trading activity of the company while being insolvent or, in other words, the duty of companies' directors to refrain from entering transactions while being insolvent (apart from those essential for the company's existence, or course) and the directors' duty to cease any payments to the companies' shareholders in case such payments may lead to the company being in the state of insolvency (a duty that expressly provides for the "shift" in respect of the addressees of the duties of companies' directors in the vicinity of insolvency from the company's

[88] *German Insolvency Statute (Insolvenzordnung)* section 15a, paragraph 1
[89] *German Stock Corporation Act (Aktiengesetz)*, section 93, paragraph 1

shareholders, as one of such addressees under the normal circumstances, to the company's creditors).

Summarizing the example from the German national legislation and their approach towards the regulation of the duties of companies' directors, we can see that again, the general bunch of the director's duties such as the duty of care and, at least in the narrow sense, the duty of loyalty etc. is located under the "umbrella" of company law. What is different from the examples of some other European Union Member States is that Germany, when it comes to the situation of the insolvency of the company, provides for the different directors' duties to be located in different sets of laws – both company and insolvency legislative acts. As it will be shown in the subsequent subchapters of the current Master's Thesis, such example is helpful for the further analysis of the main problems of the topic at hand.

2.1.3 Lithuania

Moving further, we will have a closer look to the Lithuanian national civil, company and insolvency legislation in force and will analyze the existing national legal framework in respect of the duties of the companies' directors.

The main bunch of general duties of companies' directors is located in the Civil Code of Lithuania in the article 2.87. The English translation of this article is present on the website of the Seimas of the Republic of Lithuania and provides for the following:

> *"Article 2.87.* ***Duties of Members*** *of Legal Person's Managing Bodies*
>
> *1. Member of a legal person's body shall have to* ***act in good faith and reasonable manner*** *in respect of the legal person and members of other legal person's bodies.*
>
> *2. Member of a managing body of a legal person shall* ***have to be loyal to the legal person and maintain confidentiality***.
>
> *3. Member of legal person's managing body shall have to* ***avoid a situation where his personal interests are contrary*** *or may be contrary* ***to the interests of a legal person***.
>
> *4. Member of a managing body of a legal person may* ***not confuse the property of a legal person with his own property*** *and, without consent of members of a legal person,* ***use the property or the information****, which he* ***obtains in the capacity of a member*** *of legal person's body, for his personal gain or third person's gain.*
>
> *5. A member of a managing body of a legal person* ***must notify other members of the managing body*** *of a legal person about the circumstances laid down in paragraph 3 of the given Article and define their nature and, where applicable, their value"* [emphasis added].[90]

[90] *Lithuanian Civil Code*, art. 2.87

As we can see, the article of the Lithuanian Civil Code mentioned above represents a legal framework of the regulation of the general duties of companies' directors. It includes the duty of care and duty to act in good faith; duty of loyalty; duty to avoid conflicts of interest etc. – all well-known general duties of companies' directors that can be found under national legal systems of the various EU Member-states.

If we talk about the company approaching insolvency and the possible changes to the scope or nature of the existing directors' duties of the appearance of some new duties, there are two main laws in Lithuania that regulate such issues: *Lietuvos Respublikos įmonių bankroto įstatymas* [Law on Bankruptcy of Enterprises of the Republic of Lithuania – red.] and *Lietuvos Respublikos įmonių restruktūrizavimo įstatymas* [Law on Restructuring of Enterprises of the Republic of Lithuania – red.] as Lithuania recognizes two different procedures – bankruptcy procedure and company's restructuring procedure.

The text of the provisions of the Lithuanian Bankruptcy Law can be found on the special web portal – register of legal acts that is administered by the Chancellery of the Seimas of the Republic of Lithuania and the article 8 of the Law provides for the following duty of companies' directors:

> *"Article 8.* ***Statement*** *[petition] of the head of the company or other persons according to their competence to the court in connection with the* ***opening of bankruptcy proceedings***
>
> *1. If an enterprise* ***cannot*** *and / or will not be able to* ***settle with the creditor*** *(the creditors) and the latter [creditors]* ***has not sued*** *for instituting bankruptcy proceedings, the* ***head of the company*** *[director] or other persons within the scope of their competence* ***must submit a statement*** *[petition] to the court regarding the opening of bankruptcy proceedings* ***without any delay****, but* ***not later than within 5 days*** *after the company became insolvent and the company's participants did not take measures to restore the company's solvency during the minimum time-period specified by the law or the company's founding documents for convening the meeting, but no later than within 40 days. The competent management body [director/board of directors] of such an enterprise must immediately inform the participants of the company or convene a meeting of the participants [shareholders meeting] in accordance with the minimum terms laid down in the laws or company's founding documents.* [emphasis added/ author's translation provided].[91]

[91] *Law on Bankruptcy of Enterprises of the Republic of Lithuania*, article 8

As we can see, this is a classic example of the duty of companies' management body to initiate the commencement of the insolvency [bankruptcy in our case] proceedings. This duty arises when the company faces financial difficulties.

The Law on Restructuring of Enterprises of the Republic of Lithuania imposes the following duties on the companies' directors when the company is suffering from the financial difficulties:

"Article 5. Guidelines of an Enterprise Restructuring Plan

*1. The **single-person or collegial management body** of an enterprise complying with the provisions of Article 4 of this Law and seeking the **initiation of its restructuring must prepare the guidelines** of an enterprise **restructuring plan**... The guidelines shall specify:*

1) a short description of the current situation of the enterprise (the nature of activities, assets held and number of employees);

*2) **reasons behind the financial difficulties** of the enterprise;*

*3) a **list of creditors***

..." [emphasis added].[92]

*"Article 6. **Petition to the Court** on Initiation of Enterprise Restructuring Proceedings*

*1. Upon **approving the guidelines**, the meeting of participants of an enterprise or the owner thereof complying with the provisions of Article 4 of this Law or an institution exercising the rights and duties of the owner of a state or municipal enterprise shall **endorse the candidate to the post of a restructuring administrator**, **proposed by the management** body of the enterprise, and shall adopt a decision to apply to court for initiation of the enterprise restructuring proceedings"...* [emphasis added][93]

*"Article 9. **Management** of an Enterprise **under Restructuring** and its Assets*

*1) ...shall be **prohibited to sell the enterprise** or its part, its fixed assets, real estate attributed to current assets or property rights;*

*2) ...shall be **prohibited to transfer the enterprise** or its part, its fixed assets, real estate attributed to current assets or property rights into the ownership of other persons, or to allow them to use the assets of the enterprise without remuneration;*

[92] *Law on Restructuring of Enterprises of the Republic of Lithuania*, article 5
[93] *Law on Restructuring of Enterprises of the Republic of Lithuania*, art. 6, para.1

*5. Members of the management bodies of the enterprise **shall be held liable** for **damage caused to the enterprise and/or creditors** in accordance with the procedure set forth by laws".* [emphasis added][94]

According to the provisions of the article 4 of the Law on Restructuring of Enterprises of the Republic of Lithuania, the restructuring procedure may be initiated when the company is already in the state of financial difficulties or with the existence of the possibility of occurrence of the financial difficulties within the next three months.[95]

The provisions cited above provide us with the information that when the company is approaching its insolvency but there is still a chance of successful recovery from such difficulties, the scope of the duties of the directors of such company changes and some new obligations such as the obligation to prepare of the guidelines on the restructuring plan; the prohibition to enter into financial transaction that may be harmful to the company or/and its creditors' interests. The classic "shift" towards the interests of the company's creditors is also present.

Summing up the Lithuanian experience of regulation of the duties of companies' directors, we can see that Lithuania follows the approach similar to the one of the EU Member-states that belong to the group of Civil Law countries like Germany or Austria. Lithuanian legislation in force provides for the general bunch of directors' duties such as the duty of care and the duty of loyalty to be laid down as a part of company law and for the directors' duties that appear as the company approaches insolvency to be laid down under the "umbrella" of the insolvency legislation.

2.2 PRACTICAL HURDLES ARISING OUT OF THE ISSUE OF LEGAL SOURCES OF THE DIRECTORS' DUTIES. A COURTS' PRACTICE.

As we discovered from the previous section of the current Master's Thesis, there are different approaches among the European Union Member States towards the normative consolidation of the legal provisions regarding the duties of companies' directors in their national legislation. Some EU Member-states (mainly those whose national legislation does not provide for the changes of the scope and/or nature of the directors' duties in the vicinity of insolvency) tend to regulate the duties of companies' directors as a part of the bunch of corporate or company legislation, other European jurisdictions provide for the amendments towards the scope and/or nature of the duties of companies' directors in the zone of insolvency to be described and analyzed as a part of the national courts' practice. However, many of the EU Member-states, as we could see from the various examples above, provide for the national legal framework for the duties of companies' directors to exist under the "umbrellas" of both company law and insolvency law. The

[94] *Law on Restructuring of Enterprises of the Republic of Lithuania*, art. 9, para. 3 and 5
[95] *Law on Restructuring of Enterprises of the Republic of Lithuania*, art. 4, subpara. 1

main part of the duties (the general ones like the duty of care and loyalty) are laid down as a part of the national corporate laws or company laws and the other part of the duties of directors such as the duty to initiate the opening of the insolvency proceedings are located under the auspices of the national insolvency laws. This group of countries represents the biggest interest for the author's research as the main goal of the current Master's Thesis is to analyze on the examples the existing possibilities of the appearance of the practical hurdles deriving out of such discrepancy in the national laws.

This section of the Master's Thesis is devoted to the existing case law examples of what particular obstacles can arise in cases that include a cross-border element in respect of the law applicable towards the duties of directors of companies incorporated abroad. We will have a closer look at the existing practice of Court of Justice of the European Union and will analyze the approaches towards the solution of the existing problem.

As this section of the Master's Thesis deals with the issue of the conflict of laws, we will first dive a little bit into the brief explanation of the nature of the conflict that may arise in cases that involve a cross-border element. As we previously established that some EU Member-states provide for the normative consolidation of the duties of companies' directors in the realm of both company law and insolvency law, there is a possibility that a company, that is incorporated under the laws of the one European jurisdiction but operates also in the other European jurisdiction, in certain circumstances (like the situation of the commencement of the insolvency proceedings) will be subject to different national laws. Just a brief illustration: a company incorporated in a "country A" operates in several other countries including the "country B". At a certain point in time, the company becomes insolvent and the main insolvency proceedings are commenced in the "country B". The consequence of such situation may be that the national insolvency law and national company law that is applicable to the company (for example in respect of the directors' duties) will be the laws of different countries (like the company law of the "country A" but the insolvency law of the "country B" and vice versa). Such situation will then lead to the legal uncertainty and unnecessary complications in the case.

The theoretical example described above is possible due to the different private international law rules in respect of conflict of laws. According to the provisions of the Recast of the Regulation (EU), 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, the rule behind the determination of the insolvency law applicable to the cases that were commenced in accordance with the Regulation is *lex fori concursus*. This Latin phrase that describes the rule of conflict of laws stands for the law of the jurisdiction in which a

legal action was commenced (brought before the bankruptcy/insolvency court).[96] Article 3 of the Recast Insolvency Regulation provides for the courts' jurisdiction to be determined on the basis of the concept of COMI – the centre of the debtor's main interests, with the presumption that in respect the companies or other legal persons such centre of main interests to be the place of the registered office. This presumption is, however, a rebuttable one.[97]

The substantive insolvency law that is applicable to the cases of insolvency of the companies is also determined by the Recast Insolvency Regulation. Paragraph 1 of the article 7 of the Recast Insolvency Regulation provides for the following:

> *"Save as otherwise provided in this Regulation, the* ***law applicable to insolvency*** *proceedings and their effects shall be that of the* ***Member State within the territory of which*** *such* ***proceedings are opened*** *(the 'State of the opening of proceedings')"* [emphasis added].[98]

As we can see from the provisions quoted above, the insolvency law that is applicable to the insolvency cases, including those with a cross-border element, is determined according to the conflict of laws rule – *lex fori concursus*.

On the other hand, if we talk about the substantive company law provisions that are applicable to the cases, that include a cross-border element, is determined on the basis of the different conflict of laws rule – *lex societatis* which stands for the law of the company.[99] There are several approaches across the EU Member-states as regarding the question on how to determine the jurisdiction where the company is located and thus which national jurisdiction to apply: the real seat doctrine, the incorporation doctrine and a mixed approach which represents the mixture of the first two mentioned approaches. Some countries, like the United Kingdom, apply the incorporation doctrine while others, like Germany, prefer the real seat doctrine to be applicable.[100]

It is now obvious that the provisions laid down in the Recast Insolvency Regulation regarding the applicable substantive insolvency law and the conflict of laws rules of international private law in respect of the applicable substantive company law, depending on the countries involved and the surrounding circumstances, can lead to the national substantive company and

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[96] Lex fori concursus, definition, https://www.proverbia-iuris.de/lex-fori-concursus/

[97] Recast of the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, *Official Journal of the European Union*, *L 141/19*, *05/06/2015*, art. 3

[98] Recast of the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, *Official Journal of the European Union*, *L 141/19*, *05/06/2015*, art. 7, para. 1

[99] Tsaryova, L. V. 2016. "Ограничение Сферы Действия Статута Компании Статутом Банкротства (На Примере Решения Суда ЕС)." In *The European Union and the Republic of Belarus: Getting Closer for Better Future*. Collection of abstracts II International Conference, 266

[100] Carsten Gerner-Beuerle, Philipp Paech, Edmund Philipp Schuster, "Study on Directors' Duties and Liability." London School of Economics, Department of Law, (2013), 230

insolvency law of different jurisdictions to be applicable to a one case. The court that is empowered to hear the case will be obliged to simultaneously apply the national substantive law of several countries. This situation can lead (and as we will see on the further examples has already lead) to the legal uncertainty, difficulties of the application of legal provisions and, as a result, less clarity and convergence between the European Union Member States.

2.2.1 Kornhaas v Dithmar case

Now it is time to have a closer look at one of the most well-known cases in this sphere, a case that has made a huge impact on the practice of the determination of the substantive that is applicable to the companies that commenced the insolvency proceedings – Kornhaas v Dithmar case.

This case occurred in Germany and has subsequently reached the Court of Justice of the European Union (German appeal court has referred to the CJEU with the inquiry for the preliminary ruling). The background of the case is the following:

There was a company from the United Kingdom that conducted trade activity and was registered within the trade registry in Cardiff (UK). The form of the legal entity is the UK's "private company limited by shares". Such a company conducted its activity not only nationally but also in several other countries including Germany. The company had a representation in Germany (the representative office was registered under the German legislation in the small town of Jena in its trade registry) where subsequently it faced certain financial difficulties. The director of the company was Ms Kornhaas. As the time passed, it turned out that the main part of the company's activity was conducted in Germany (the activity of the company was mainly connected with the services on installation of the ventilation equipment and the provision of other related works).[101]

As the company faced some financial turbulence during its activity, the insolvency proceedings were commenced according to the national insolvency legislation of Germany. The insolvency practitioner was appointed – Mr Tomas Dithmar. After the due diligence procedure and the analysis of the activity of the company, its assets, and contractual obligations, the insolvency practitioner decided to lodge a claim against Ms Kornhaas. It was done in accordance with the German national legislation, in particular – sentence 1 paragraph 2 section 64 of the

[101] Tsaryova, L. V. 2016. "Ограничение Сферы Действия Статута Компании Статутом Банкротства (На Примере Решения Суда ЕС)." In *The European Union and the Republic of Belarus: Getting Closer for Better Future*. Collection of abstracts II International Conference, 265

German Limited Liability Companies Act [GmbHG].[102] The provision quoted above refers to the liability for payments following illiquidity or over-indebtedness and provides for the following:

> *"The **directors** shall be **obligated to compensate** the company **for payments** made **after the company has become illiquid** or after it is deemed to be over-indebted"* [emphasis added].[103]

The insolvency practitioner was of opinion that the company's director Ms Kornhaas violated the requirement of the requirement of the German national company law regarding the prohibition of conducting any trading activity apart of the performance of the contracts that are essential for the existence of the company. Mr Dithmar referred to the court with the claim to reimburse the financial loss that the company suffered as a result of the performance of the trading activity after the date when the company deemed to be in the state of insolvency. In our case – from 1 November 2006.[104]

The insolvency practitioner claimed that Ms Kornhaas conducted some episodes of trading activity in the period from 11 December 2006 to 26 February 2007. The amount of the funds taken out of the company's pool of financial assets was claimed to equal 110,151.66 EUR.[105]

The court of the first instance – Amtsgericht Erfurt [Local Court of Erfurt – red.] in Germany landed a judgment where agreed with the Mr Dithmar's claims. An appeal was lodged by the representatives of Ms Kornhaas to the Higher Regional Court of Jena and subsequently, the case appeared before the Bundesgerichtshof [German Federal Court of Justice] where a review had to be made on a point of application of the law.[106]

The German Federal Court of Justice was of opinion that the action brought by the insolvency practitioner, Mr Dithmar, on the basis of the German law in force was a well-founded one. According to the judges' point of view, the purpose of the provision laid down in the article 64 of German Limited Liability Companies Act is to "prevent the assets of the insolvent estate being reduced before the opening of the insolvency proceedings and to ensure that those assets are available, so that the claims of all the company's creditors can be satisfied in the insolvency

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[102] Tsaryova, L. V. 2016. "Ограничение Сферы Действия Статута Компании Статутом Банкротства (На Примере Решения Суда ЕС)." In *The European Union and the Republic of Belarus: Getting Closer for Better Future*. Collection of abstracts II International Conference, 265

[103] *German Limited Liability Companies Act (Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG)* section 64

[104] Tsaryova, L. V. 2016. "Ограничение Сферы Действия Статута Компании Статутом Банкротства (На Примере Решения Суда ЕС)." In *The European Union and the Republic of Belarus: Getting Closer for Better Future*. Collection of abstracts II International Conference, 265

[105] Tsaryova, L. V. 2016. "Ограничение Сферы Действия Статута Компании Статутом Банкротства (На Примере Решения Суда ЕС)." In *The European Union and the Republic of Belarus: Getting Closer for Better Future*. Collection of abstracts II International Conference, 265

[106] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016)

proceedings on equal terms".[107] Also, and this a crucial point, the German Federal Court of Justice was assured that even despite the fact that the provision of the German GmbHG cited above was formally laid down under the auspices of the national company law, falls also under the "umbrella" of the insolvency law and, therefore, is enforceable against a managing director of a limited company.[108]

What was not entirely clear for the Federal Court of Justice is the issue of compatibility and consistency of such national provision with the European Union Law. As the insolvency proceedings that were initiated in Germany were opened on the basis of the Council Regulation EC No 1346/2000 on Insolvency Proceedings (the old Insolvency Regulation), article 4 of which states that the law applicable to insolvency proceedings and their effects should be the law of the state within which territory the insolvency proceedings were commenced[109] [German national law in our case], there was still no agreed single position among German scholars and practitioners on the issue whether the provisions of the article 64 of the German GmbHG could be enforceable against directors whose companies were incorporated in accordance with the law of the other European Union Member States, but having their centre of main interests in Germany [which was the case Ms Kornhaas's company].[110] The reason for such doubts on the side of the German Federal Court was simple as the wording of the provision of the article 64 of the German Limited Liability Companies Act is not precise enough to encompass the situation when a company that is registered in accordance of the national law of another EU Member-state [the United Kingdom in our case] but moved its administrative office, where the main decision-making process was conducted by the company's directors, to Germany. In addition to that, the German Federal Court was of opinion that the provision of the article 64 of German GmbHG did not affect the freedom of establishment prescribed by the Treaty on Functioning of the European Union.[111] German judges were convinced that even if the relevant provisions of the German GmbHG do place certain restrictions on the freedom of establishment, such restriction should be recognized as being justified. The reasoning behind such line of thinking was the following:

> *"(i) it is [the provision of the article 64 of the German GmbHG] applied* ***without discrimination****, (ii)* ***corresponds to*** *an overriding reason in* ***the public interest****, namely to* ***protect creditors****, (iii) is* ***suitable for preserving the assets*** *of the insolvent estate or*

[107] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.8
[108] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.8
[109] Council Regulation EC No 1346/2000 on Insolvency Proceedings, *Official Journal L 160, 30/06/2000*, article 4
[110] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.9
[111] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.10

restoring them, and (iv) ***does not go beyond what is necessary*** *in order to attain that objective"* [emphasis added].[112]

However, despite the above quoted arguments, the German Federal Court of Justice did have some concerns over the existing case law that did contained some signs that the possibility of the infringement of the freedom of establishment within the meaning of the Articles 49 and 54 of the Treaty on Functioning of the European Union can still be in place. Those concerns were grounded on the following examples of the previous case practice:

"…the judgments in ***Überseering*** *(C-208/00, EU:C:2002:632) and* ***Inspire Art*** *(C-167/01, EU:C:2003:512)* ***could also be interpreted*** *as meaning* ***that the internal affairs*** *of* ***companies established in one Member State but carrying on their*** *main* ***operations in another*** *Member State* ***are****, in the context of freedom of establishment,* ***governed by the company law of the Member State of formation [****which is the UK in our case****]. The* ***application*** *of the first sentence of Paragraph* ***64(2) GmbHG to managing directors*** *of companies of another Member State* ***could accordingly infringe freedom*** *of establishment…"* [emphasis added].[113]

Having the concerns quoted above in place, the German Federal Court of Justice has referred to the Court of Justice of the European Union for a preliminary ruling with two straightforward questions:

"(1) If a ***liquidator brings an action before a German court against a director*** *of* ***a private company*** *limited by shares* ***under the law of England*** *and Wales, in respect of whose assets in Germany insolvency proceedings have been opened pursuant to Article 3(1) of Regulation No 1346/2000, the purpose of the action being* ***to seek reimbursement of payments which the director made*** *before the opening of the insolvency proceedings but after the company had become insolvent,* ***is that action governed by German insolvency law*** *within the meaning of Article 4(1) of Regulation No 1340/2000?*

(2) ***Does an action*** *as referred to above* ***infringe freedom of establishment*** *under Articles 49 and 54 TFEU?"* [emphasis added].[114]

As the above mentioned questions (especially the first one) represent the biggest interest for us and answers tow which can bring light to the issues that constitute the core problematic of the current Master's Thesis, we will dive deeper into the analysis that the CJEU provided in its preliminary ruling in the Kornhaas v Dithmar case.

[112] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.11
[113] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.12
[114] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.13

2.2.1.1 The first question

Answering the first question, the Court of Justice of the European Union addressed the main concern of the case at hand – the issue of coverage of the action taken by the German insolvency practitioner against the company's director – Ms Kornhaas – by either the German national insolvency law or company law.

The CJEU emphasized several important points. First, it mentioned that in the Court's previous judgements it was specified that the Article 3(1) of the old Insolvency Regulation No 1346/2000 should be interpreted in the way that allows EU Member-states' national courts, while hearing the cases related to the claims for reimbursement of the payments made by the companies' directors after the point when the company has entered in the vicinity of its insolvency, to determine an action that should be applied in respect of such company's director [judgment in H, C-295/13, EU:C:2014:2410, paragraph 26].[115] On top of that, the CJEU interpreted the provision of Paragraph 64(2) of the national German GmbHG as such that derogates from the common rules of the of civil and commercial law. The Court stated that such derogation is due to the insolvency of the company and, thus, in these circumstances, [the action against the company's director] should be described as the one deriving directly from the insolvency proceedings and closely connected with such proceedings.[116]

Following such line of thinking, the CJEU has formulated the key position in respect of the first question raised by the German Federal Court of Justice:

> *"It follows that Paragraph 64(2) of the GmbHG* ***must be regarded as being covered by the law applicable to insolvency proceedings*** *and their effects,* ***within the meaning of Article 4(1) of Regulation*** *No 1346/2000. As such,* ***that provision of national law*** *[article 64(2)], one of the effects of which is to require, if necessary, the managing director of a company to reimburse any payments which he made on behalf of that company after it became insolvent,* ***may****, in accordance with Article 4(1) of Regulation No 1346/2000,* ***be applied by the national court hearing the insolvency proceedings*** *as the law of the Member State within the territory of which the insolvency proceedings are opened ('the lex fori concursus')"* [emphasis added].[117]

In addition to that, the Court of Justice of the European Union reinforced its position on the provision contained in the paragraph 2 of the article 64 of the German GmbHG as such that can be covered by the "umbrella" of the national insolvency law by providing for an additional

[115] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.15
[116] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.16
[117] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.17

clarification of the scope of the article 4 of the old Insolvency Regulation, pointing out, in particular, the following statements:

1. As the *lex fori concursus* determines the "conditions for the opening of the insolvency proceedings", the following actions should be provided under the "umbrella" of the insolvency law: the preconditions of the opening of the insolvency proceedings itself; the rules designating the persons that are responsible for the initiation of the insolvency proceedings and the consequences of a violation of the requirement to file for the commencement of the insolvency proceedings.[118]

2. More to the above-mentioned, the CJEU stated that provisions such as those contained in the article 64 of the German GmbHG "*...**contributes to the attainment of an objective** which is intrinsically linked, mutatis mutandis, to all insolvency proceedings, namely the **prevention of any reduction of the assets of the insolvent estate** before the insolvency proceedings are opened, so that the claims of all the company's creditors may be satisfied on equal terms. Accordingly, **such a provision** appears at least similar to a rule laying down the 'unenforceability of legal acts detrimental to all the creditors' which, under Article 4(2)(m) of Regulation No 1346/2000, **comes within the lex fori concursus**"* [emphasis added].[119]

As we can see, the Court of Justice of the European Union was straightforward in its answer to the first question of the German Federal Court of Justice and confirmed that the action taken by the German insolvency practitioner against the director of the company that was registered under the law of the United Kingdom but subsequently moved its centre of main interests to Germany, and constitutes in its essence the claim of the existing violation of one if the duties of compamnies' directors, namely the duty to refrain from the performance of any trading activity when the company is in the vicinity of insolvency, is covered by the "umbrella" of German insolvency law and not company law.

2.2.1.2 Second question

The second question raised by the German Federal Court of Justice does not constitute the primary interest of the current research, however, it is still important from the perspective of the fulfilment of the principles laid down in the Treaty on Functioning of the European Union – the so-called "four freedoms" and more particularly, the freedom of establishment. This issue is of considerable significance as the successful implementation of the principles prescribed by the

[118] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.19
[119] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.20

TFEU has an impact on the convergence of the European Union. As one of the goals of almost any students' Master's Thesis in the sphere of law is the research of the possible solutions to the existing problems and/or gaps in the existing legal regulations in various spheres of law within the European Union, any legal problem whose effective resolution may contribute to the convergence of the laws within the EU is of paramount importance. Hence, for the sake of completeness of the current research, it is also important to highlight the legal issue that was addressed in the second part of the CJEU's preliminary ruling in the Kornhaas v Dirhmar case.

Answering the second question, the Court of Justice of the European Union painted out the following arguments. First of all, the Court reiterated that the previous experience of the similar cases indicates that indeed in certain circumstances if one of the EU Member-state does refuse to recognize the legal capacity of the company that was incorporated with the national law of the other Member State on the ground that such company has transferred its centre of main interests to the territory of this [the former] Member State, that situation may constitute a restriction to the freedom of establishment incompatible with the rules laid down in the Articles 49 and 54 of the TFEU [judgment in Überseering, C-208/00, EU:C:2002:632, paragraph 82].[120] At the same time, the CJEU emphasized that in the current case, the provision of paragraph 2 of the article 64 of the German GmbHG does not constitute the refusal by a host EU Member-state to recognize the legal capacity of the company that has been registered in the other EU Member-state and just moved its COMI to the host jurisdiction. The provision of German legislation at hand in no way called into question the context of the case in the main proceedings, it only refers to the situation of the breach of one of the duties of companies' directors in a situation when the company is in the zone of insolvency. The provision itself even reaffirms that there should be a lawfully registered company [thus indirectly recognizes the legal capacity of the company itself as the commencement of the insolvency proceedings is prescribed in relation to the validly formed companies].[121]

Taking into consideration the above-mentioned arguments, the CJEU has reached the conclusion that: a) the relevant provision of the German GmbHG does not constitute the restriction to the freedom of establishment prescribed by the articles 49 and 54 of the Treaty on Functioning of the European Union and b) the mentioned provisions of the TFEU do not place any obstacles to the application of a national provision prescribed by the Paragraph 64(2) of the GmbHG to a managing director of a company established under the national laws of the UK which is the subject of insolvency proceedings opened in Germany.[122]

[120] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.23
[121] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.25 and 26
[122] CJEU, Case C-594/14, Kornhaas, judgment of 10 December 2015, ECLI:EU:C:2015:806, para.28 and 29

Summarising the CJEU's analysis of the case, we can see that the Court made a quite strict decision and determined that in certain situations when a company is operating in a jurisdiction that is distinct from the one within which such company was incorporated, if the state of insolvency occurs and the insolvency proceedings are commenced, the company's directors can face the reality of being liable for their actions and decisions under the national company law of the country where they operate. Such situation, from the point of view of the judges of the Court of Justice of the European Union, is justifiable merely because the relevant company law or corporate law provisions are "closely linked" with insolvency. This judgment has soon become the cornerstone and an important starting point for the national courts of the EU Member-states when determining the substantive law that should be applicable to the case that contains a cross-border element. The case has become sort of a guide for the judges to refer to in situations of the uncertainty on what law to apply and subsequently the provision that has its roots in the *Kornhaas v Dithmar case* was implemented by the drafters of the Recast Insolvency Regulation in order to facilitate the process of successful and prompt resolution of the courts' cases related to the insolvency proceedings that involve a cross-border element.

That being said, the CJEU's *Kornhaas v Dithmar* preliminary ruling creates more questions than it provides answers in respect of the legal certainty in the field of the applicable substantive law in insolvency proceedings. The position of the CJEU has faced some strong opposition from the scholars and practitioners in the relevant field of law. In the further sections of the current Master's Thesis, we will see the different opinions on the subject matter as well as the connection between the *Kornhaas v Dithmar case* and the Recast Insolvency Regulation.

2.2.2 Criticism of the CJEU's approach in the Kornhaas v Dithmar case

Soon after the preliminary ruling on the Kornhaas v Dithmar case was issued by the Court of Justice of the European Union, it faced a lot of criticism for being too fact specific[123] and/or for setting the judicial precedent that cannot be used effectively as a template by the EU Member-states other than those who participated in the dispute between Ms Kornhaas and Mr Dithmar due to the substantial differences in national company law and insolvency law regulations of different European jurisdictions. Some of the scholars and practitioners in the relevant fields of law argue that *Kornhaas v Dithmar case* has led to even bigger legal uncertainties in the relations between the company law and insolvency law within the EU and particularly in the sphere of duties of companies' directors. Some of the scholars, like prof. Wolf-Georg Ringe in his article "Kornhaas

[123] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 116.

and the Limits of Corporate Establishment", even assumed that the CJEU was in the state of "mental blackout"[124] while adopting such a decision.

In this subsection of the Master's Thesis we will elaborate more on the above-mentioned lines of criticism in respect of the *Kornhaas v Dithmar case* as it will allow us to look at the problematic of the collision between the company law-based and insolvency law-based duties of companies' directors and the possible consequences of such a legal uncertainty from the various points of view and to have a broader picture of the problem that constitutes the main concern of the current Thesis.

First of all, it should be mentioned that the CJEU took quite a fact-specific approach while drafting its decision on the *Kornhaas v Ditmar case* as the analysis was conducted in the relation of the single provision of the German GmbHG [art. 64] and its connection with the bunch of German company law or insolvency law. Sure, it is natural that the Court analyzed the factual basis and the legal arguments as it was presented in the application for the preliminary ruling. But at the same time, it is hard to imagine that the judges of the Court of Justice of the European Union could not understand that any preliminary ruling that the Court issues will subsequently be used as a template for the solution of the similar legal uncertainties arising in other EU Member-states. In this regard, the situation that the CJEU's decision on *Kornhaas v Dithmar case,* as it will be shown below, cannot be effectively used as a template by many practitioners in various European jurisdictions has a negative impact on the reputation and the credibility of the Court as a European Union institution.

As an example of the critique of the *Kornhaas decision,* we can use a briefing note prepared by the well-known law firm that operates in various EU Member-states – Clifford Chance. According to the law firm's practicing lawyers, *Kornhaas v Dithmar 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*"[125]. The idea behind such an argument was that it could also be possible by the national German court to apply the rules on the prohibition of engaging in the wrongful trading by the company's director that are located in the UK's national legislation and to reach the same result – to oblige the director of the company that has become insolvent to reimburse the damage that was committed towards the creditors' interests. In other words, there was no need to ascribe the provision of the article 64 of the German GmbHG to the bunch of the national insolvency law of Germany in order to justify the application of the German substantive law to the case at hand (as required by the article 4 of the Insolvency regulation [now

[124] Wolf-Georg Ringe, "Kornhaas and the Challenge of Applying Keck in Establishment." *European Law Review*, no. 2, (2016)

[125] "European Court Finds Directors of English Company May Be Liable for Breach of German Company Law.", Clifford Chance (2016), 3.

article 7 of the Recast Insolvency Regulation]) if the same result could be achieved by virtue of usage of the substantive law determined on the basis of the *lex societatis.*

Another important concern that was raised by the practitioners form the Clifford Chance was the issue of the extrapolation of the *Kornhaas v Dithmar* preliminary ruling on the cases outside Germany or the UK. As it was stated by David Towers, a partner in the restructuring and insolvency department in London office of Clifford Chance, "*it is not however free from doubt in* ***other Member States where similar obligations may apply****…, Nor does the case consider whether the* ***criminal sanctions relating to a failure to file also apply***." [emphasis added].[126] This means that the Kornhaas case may be sort of useful as a guiding tool for the German national courts that can face the similar issues, but it fails to act as a useful template for other EU Member-states where national provisions may be different from the German approach. On top of that, the CJEU's case mentioned does not solve the issue of the liability for the companies' directors for breaches of their duties that may be located in national criminal or tort law.

The above-mentioned concerns came from the practicing lawyers who face similar sensitive issues in their day-to-day work. Even more to that, some well-grounded criticism was presented by scholars whose research interest lies in the field of interrelation of the substantive law provisions on the directors' duties and liability in EU Member-states national company law and insolvency law. Some of such concerns were described by prof. Wolf-Georg Ringe in his article "Kornhaas and the Challenge of Applying Keck in Establishment". For example, it was stated in the article that one of the main reasons for the recognition of the provision of the article 64 of the GmbHG as the one that has an insolvency law nature was the fact that the triggering event for the liability based on that article to occur was the situation of insolvency of the company. If the company is in the "vicinity of insolvency", then the directors of such company should obey the rules laid down in the article 64 of GmnHG. The author of the article claims this to be a wrong position and that the liability if the article 64 is not always tied to the opening of the insolvency proceedings.[127] The reasoning behind such author's position is that the companies' directors should remain to be liable under such German provision in case the application for the commencement of the insolvency proceedings was rejected (due to lack of assets etc.) or where the liquidation proceedings were cancelled because the parties involved agreed on and confirmed the "insolvency plan".[128]

Taking into consideration the fact that the art. 4 of the old Insolvency Regulation [art.7 of the Recast Insolvency Regulation] is construed explicitly with the reference towards the opening

[126] "European Court Finds Directors of English Company May Be Liable for Breach of German Company Law.", Clifford Chance (2016), 3.
[127] Wolf-Georg Ringe, "Kornhaas and the Limits of Corporate Establishment." (2016), 273.
[128] Wolf-Georg Ringe, "Kornhaas and the Limits of Corporate Establishment." (2016), 273.

of the insolvency proceedings, article 64 of the German GmbHG does not fit into the system of the Insolvency Regulation. The author of the article proposes to ascribe the provision behind the article 64 to the bunch of liability rules under the "umbrella" of the national substantive company law[129] and supports his point of view with an allegation that the stringent liability standard for any violations of the duties by the companies' directors in the GmbHG creates incentives that have an *ex-ante* effect on the companies' directors behaviour – such rules influence the directors long before the state of the vicinity of insolvency even occurs.[130]

In addition to the above-mentioned arguments, the author also repeats the idea that has already been expressed in the Clifford Chance's analytical material – the Court of Justice of the European Union could have referred to the possibility of the application of the quite similar provision of the UK's national law – the concept of wrongful trading in order to achieve the same goal – the protection of the company's creditors' interests.[131] So, again we can see that both scholars and practitioners are confused by the question on why the CJEU was reluctant to use probably the more convenient ways of protection of the company's creditors and went instead into the vague justification of the "insolvency nature" of the provision of the art. 64 of the German GmbHG.

Another one possible drawback of the JCEU's decision in *Kornhaas v Ditmar case* which is more connected with the national legislative policy issues was illustrated by Loes Lennarts in the article "Directors in the Twilight Zone – *Kornhaas* and "Beyond" – some Observations from a Dutch Perspective". The author of the article agrees with the other critical points that has been raised by the scholars and practitioners in the relevant field of law in respect of the *Kornhaas case* but goes even further and claims that the precedent created by the CJEU can lead to the situation of the so-called "insolvencification"[132] of the national law provisions in the field of the duties and liability of the companies' directors in order to ensure that in case the dispute has a cross-border element, the rule of *lex concurus* will be applied and the national legal provisions of the EU Member-state where the insolvency proceedings have been commenced will be applicable. The author of the article argues that the EU Member-states' national legislative authorities may tend to "relabel" certain provisions of their national law of the duties of companies' directors in order to fit them under the "umbrella" of the national insolvency law and to subsequently apply the rule on determination of the applicable substantive law laid down in the Recast Insolvency Regulation [the rule that provides for the national substantive law that belongs to the bunch of insolvency law

[129] Wolf-Georg Ringe, "Kornhaas and the Limits of Corporate Establishment." (2016), 273.
[130] Wolf-Georg Ringe, "Kornhaas and the Limits of Corporate Establishment." (2016), 273.
[131] Wolf-Georg Ringe, "Kornhaas and the Limits of Corporate Establishment." (2016), 273.
[132] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 117.

of the state where the insolvency proceedings were commenced to be applicable to the case that contains a cross-border element]. German, as well as Belgian experience, as examples of such an approach, are brought to the readers' attention.[133]

In addition to the above-mentioned dangerous tendency that occurs within the EU in respect of the "requalification" of the national provisions in order to shift them from the company law to the insolvency law domain, the author of the article also reiterates the issue of the problem of using the CJEU's *Kornhaas v Dithmar case* as a universal framework across the European Union. The author claims that even if the CJEU's decision is helpful for some European jurisdictions and do bring certain degree of legal certainty in the problem of the allocation of the duties of companies' directors to either company law or insolvency law, it cannot be used in universally as, for example, the Dutch experience shows that the provisions related to the duties of companies' directors are mostly located under the domain of the national company law or even tort law[134] and there is little room across the scholars for disputes there[135]. As we can see, all this renders the *Kornhaas v Dithmar case* kind of useless in providing the clear separation between the company-based and insolvency-based duties of companies' directors and, thus, provides little support to the directors of the companies themselves as regarding the legal aspects of the "migration" of the company into another EU jurisdiction.

2.2.3 The duties of companies' directors and the Recast Insolvency Regulation. The interrelation of the new EIR and the *Kornhaas v Dithmar case*.

The CJEU's case that we paid a lot of attention during the previous sections of the current Master's Thesis was issued at the time when the Council Regulation (EC) No 1346/2000 on insolvency proceedings was in force. Since then the new EIR – the Recast Regulation (EU) 2015/848 of the European Parliament and of the Council on Insolvency Proceedings has come into play and brought some notable changes that also influence the main topic of the Thesis, so it is time to have a closer look at this document and to find out whether the problem of the substantive law applicable to the cases regarding the duties of companies' directors that involve a cross-border element has been eliminated or it is still there.

[133] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 117; 118.
[134] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 122.
[135] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 123.

Some of the practitioners and scholars from the EU Member-states (this is true, for example for the United Kingdom[136] and Spain[137]) noted the adoption and entry into force of the Recast Insolvency Regulation have led to the reduction in the effects of divergence in respect of the cases that involve a cross-border element. It was achieved mainly due to the implementation of the new provision that was not present in the old Insolvency Regulation about the actions that derives directly or closely linked with the insolvency of the company. The wording of the provision is the following:

> *"Article 6*
>
> *Jurisdiction for* ***actions deriving directly from insolvency*** *proceedings* ***and closely linked*** *with them*
>
> *1. The courts of the Member State within the territory of which insolvency proceedings have been opened in accordance with Article 3 shall* ***have jurisdiction for any action which derives directly from the insolvency proceedings and is closely linked with them****, such as avoidance actions.*
>
> *...*
>
> *3. For the purpose of paragraph 2,* ***actions are deemed to be related*** *where they are* ***so closely connected that it is expedient to hear*** *and determine* ***them together*** *to avoid the risk of irreconcilable judgments resulting from separate proceedings"* [emphasis added].*[138]*

As we can see, at the first glance it may seem that the drafters of the Recast Insolvency Regulation did accept the CJEU's approach and reflected the similar position in the text of the Regulation. But, as usual, the devil is in the details: apart from the mere fact that the provisions of the art. 6 of the Recast EIR are themselves not very precise as they do not provide for the clear separation of what are the provisions that are closely linked with the insolvency proceedings and what are not so, the more in-depth analysis of the proposals for the text of the regulation as well as the text of the recitals of the Recast EIR shows as that even the drafters themselves lacked the unanimity in respect of this issue.

First and foremost, the wording of Recital 16 of the Regulation needs to be analyzed as the recitals also constitute inalienable part of any EU's regulation. Recital 16 provides us with the following provisions:

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[136] "European Court Finds Directors of English Company May Be Liable for Breach of German Company Law.", Clifford Chance (2016), 3.

[137] Gerard McCormak et al. "Study on a New Approach to Business Failure and Insolvency. Comparative Legal Analysis of the Member States' Relevant Provisions and Practices.", University of Leeds, 2016, Tender No. JUST/2014/JCOO/PR/CIVI/0075, 57

[138] Recast of the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, *Official Journal of the European Union, L 141/19, 05/06/2015*, art. 6, para. 1 and 3.

"This Regulation should ***apply to proceedings which are based on laws relating to insolvency. However, proceedings that are based on general company law*** *not designed exclusively for insolvency situations* ***should not be considered to be based on laws relating to insolvency****…"* [emphasis added].[139]

This brings us to the interesting situation that, as recitals of any regulation reflect the drafters' intentions and rationale behind the regulation itself, we can now see that drafters of the Recast Insolvency Regulation did not pursue the idea to allow the national courts of the EU Member-states to be free in the ascription of the national rules (including the rules on the duties of companies' directors) to the bunch of laws under the "umbrella" of the national insolvency law when deciding on each particular case that involves a cross-border element. Recital 16 rather places an important limitation to such freedom of the courts to "insolvencify" the provisions of the national law. On top of that, the idea behind the Recital 16 seems to contradict the position of the CJEU in *Kornhaas v Dithmar case.* As a result, there is room for concern among the scholars regarding the situation whether the principle in Recital 16 supersedes the earlier Court's preliminary ruling. The researchers from Max Planck Institute and the University of Vienna in their work called "The Implementation of the New Insolvency Regulation – Recommendations and Guidelines" co-founded by the European Union presented their point of view on the topic and reached the conclusion that the answer to the above question is rather negative. The researchers have received mostly negative responses to that question from the stakeholders to whom the appropriate questionnaire has been submitted.[140] The rationale for such responses was mainly the fact that first, it is questionable that actions based on the article 64 of the GmbHG are not designed to be used solely when there is an insolvency of the company [at the same time, as we discussed in the section of the Thesis that is devoted to the criticism of the *Kornhaas case*, some scholars are of an opinion that the provision of the article 64 of the GmbHG has a company law nature]; second, most actions that can be brought before the court by insolvency practitioners lie on the intersection between the company law and insolvency law. If all such actions would be set aside of the scope of the Recast Insolvency Regulation, this will lead to the weakening of the principle of *vis attractiva concursus* established by the article 6 of the Recast EIR.[141] And finally, what is deemed to be even more crucial, is the fact that there is a prevailing opinion among the scholars that is formulated in the following way:

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[139] Recast of the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, *Official Journal of the European Union, L 141/19, 05/06/2015*, Recital 16.

[140] "The Implementation of the New Insolvency Regulation – Recommendations and Guidelines." n.d. Max Planck Institute. http://insreg.mpi.lu/Guidelines.pdf. UST/2013/JCIV/AG/4679, 51.

[141] "The Implementation of the New Insolvency Regulation – Recommendations and Guidelines." n.d. Max Planck Institute. http://insreg.mpi.lu/Guidelines.pdf. UST/2013/JCIV/AG/4679, 51.

"…Recital 16 seems to be ***tailored to collective proceedings***, ***not to actions directly deriving and closely connected with the them****: in fact, the expression 'proceedings based on laws relating to insolvency' used in recital 16 is used* in *Article 1(1),* ***which deals only with collective proceedings****; moreover, 'insolvency-related' actions, in the text of the EIR-R* [Recast Insolvency Regulation], *are always referred to as 'actions', not as 'proceedings'*" [emphasis added].

The above-mentioned clarifications do bring a bit of clarity to the question of the interrelation between the *Kornhaas v Dithmar case* and the Recast Insolvency Regulation, however, it should be also mentioned, that the opinion of the majority of the scholars and practitioners does not mean the unanimity of the approach and, thus, leaves the room for uncertainty.

Previously, when describing the provisions of the article 6 of the Recast Insolvency Regulation, it was mentioned that by the author of the current Master's Thesis that those provisions have a certain degree of ambiguity meaning that they are rather vague. In support of that bold statement an example of the proposal prepared by the European Parliament for the draft of the Recast Insolvency Regulation can be highlighted that shows that before the adoption of the final text of the Regulation drafters had a distinct opinion on the wording of the provisions at hand. One of the proposals of the European Parliament for the draft of the Recast Insolvency Regulation, namely the amendment No 22 provided for the following wording of the future provision:

"*…action* ***directly deriving from insolvency*** *proceedings and* ***closely linked*** *with them"* ***means an action directed at obtaining a judgment that****, by virtue of its substance, cannot be, or* ***could not have been, obtained outside of, or independently from, insolvency proceedings****, and that is* ***exclusively admissible where insolvency proceedings are pending***" [emphasis added].[142]

As we can see from the wording of the proposal, it is definitely more precise than the final variant of the provision that has been subsequently adopted and now constitutes the part of the article 6 of the Recast Insolvency Regulation. The text of the proposal places a clear limitation principle between the actions that could be treated as those that derive directly from insolvency and all others. Prof. Wolf-Georg Ringe is of opinion that if such a proposal were accepted as the

[142] "Legislative resolution of 5 February 2014 on the proposal for a regulation of the European Parliament and of the Council amending Council Regulation 1346/2000 on insolvency proceedings". European Parliament, (COM(2012)0744-C7-0413/2012–2012/0360(COD)), amendment 22 (inserting new art.2(g)(a)). See Committee on Legal Affairs, Report on the proposal for a regulation of the European Parliament and of the Council amending Council Regulation 1346/2000 on insolvency proceedings of 20 December 2013 (COM(2012)0744 — C7-0413/2012 — 2012/0360(COD)) (*Rapporteur: K.-H. Lehne*)

final version, it would render the liability claims based on the article 64 GmbHG to fall outside the scope of the Recast Insolvency Regulation.[143]

As we can see, the uniform approach towards the proper regulation of the clear separation of the duties of companies' directors that are of company law nature and insolvency law nature can be found neither among the scholars and practitioners in the relevant field, nor among the drafters of the legal provisions of the Recast Insolvency Regulation. All this indicates that the existing practice of the CJEU as well as the New EIR is not sufficient enough to bring the legal certainty into the issue that constitutes the core problematic issue of the current Master's Thesis.

2.3 THE CONSEQUENCES OF THE LACK OF LEGAL CERTAINTY IN THE FIELD OF THE DUTIES AND LIABILITY OF COMPANIES' DIRECTORS AND POSSIBLE SOLUTIONS

So, as we established that there is a problem with the lack of legal certainty and the fact that the existing case law and the secondary legislation within the European Union cannot effectively cover all the possible practical hurdles that may appear in cases that involve a cross-border element, it is time to analyse the possibilities of negative trends that may occur if this issue is left without due consideration.

As the problem at hand is not the newest one and it remains to be in place for a couple of years, there are several researches out there that addressed the issue of the legal uncertainty in the field of application of the company law-based and insolvency law-based provisions regarding, *inter alia*, the duties of the companies' directors in the cases with a cross-border element. Some of the researchers like prof. Loes Lennarts have drafted several hypothetical scenarios in which the lack of legal certainty in cross-border cases regarding the duties of directors may hamper the convergence of the common European legal field. The two hypotheticals that represent the biggest interest for us are laid down in prof. Lennarts's research named "Directors in the Twilight Zone – Kornhaas and 'Beyond' – some Observations from a Dutch Perspective".[144]

2.3.1 Analysis of the hypothetical scenarios

According to the **first hypothetical scenario**, if, for example, we have a private limited company registered under the Dutch national law which moved its COMI to Germany, and its sole director, who is domiciled in the Netherlands, puts the company into the state of insolvency by making an unreasonable and unjustifiable payment to one of the company's creditors, we then have a situation when the German insolvency practitioner is entitled (on the basis of the art. 64

[143] Wolf-Georg Ringe, "Kornhaas and the Challenge of Applying Keck in Establishment." *European Law Review*, no. 2, (2016), 274.

[144] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 127.

GmbHG and according to the CJEU's *Kornhaas* judgement) to bring a claim before the German court against such company.[145] So far so good, but taking into consideration that some of the duties of directors in the Netherlands are of the tort law nature, one or more of the company's creditors, under certain circumstances, may bring a claim against the director in a Dutch court for allowing selective payments (Brussels Ibis and Rome II Regulations allow creditors to do that). The result would be the possibility of having several claims against the director handled by courts in different EU Member-states.[146] Needless to say that the situation at hand is not beneficial for the national courts that even without such similar claims have enough working volume.

The **second hypothetical** might lead to even more harmful results for the effectiveness of the protection of the rights of companies' creditors in the vicinity of insolvency. In this scenario prof. Lennarts describes the following situation: There is a private limited company that was registered in Germany but has its COMI moved to the Netherlands. The sole director of the company, who domiciles in Germany, makes an unwise yet deliberate payment to one of the company's shareholders that puts the company into the state of insolvency. The main insolvency proceedings are commenced in the Netherlands.[147]

The problem here consists of the impossibility for the Dutch insolvency practitioner to invoke the Art. 2:216(3) DCC [the Dutch Civil Code] as it only applies as a part of the *lex societatis* meaning that it belongs to the bunch of corporate law and not of the insolvency law-nature. On the other hand, the insolvency practitioner cannot force the Dutch national court to apply a similar German provision (the Art. 64 GmbHG) because the existing CJEU's practice (*Kornhaas v Dithmar case*) determines the provision of the Art. 64 of the GmbHG as the one that belongs to the national insolvency law and should be applicable as part of the *lex concursus.*[148] The problem seems to be of an artificial nature – the collision of the national laws that lead to neither national law to be applicable. But whatever the nature of the problem, it remains to be in place. In addition to that, the Dutch court would find troubles trying to solve this issue even by referring to the provisions of the Recast Insolvency Regulation. Previously, during the section of the Thesis that is devoted to the role of the New EIR in the resolution of the problem at hand, we saw that the

[145] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 127.
[146] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 128.
[147] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 128.
[148] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 128.

provisions of the Art. 6 of the Recast Insolvency Regulation, as well as its Recital 16, are ambiguous and might even contradict each other.[149]

The hypotheticals described above are just a simple illustration of the existence of the problem regarding the applicable law on the duties of companies' directors in cases that involve a cross-border element. These examples show the weaknesses of the approach taken by the European Court of Justice in its *Kornhaas v Dithmar case* as well as the possible contradictions of the provisions on the applicable national law that are laid down in Recast Insolvency Regulation.

2.3.2 The possibilities of improvement of the existing situation

In this section of the Master's Thesis we will look at the possible amendments to the existing European normative acts that were proposed by various researchers and practitioners in the relevant field that can improve the situation of the lack of legal certainty in the sphere of applicable law in respect of the duties of directors in cases that involve a cross-border element.

Scholars and practitioners have currently elaborated proposals for several lines of possible improvement of the situation that occurred in the sphere of the laws applicable in cases with a cross-border element. These actions can be adopted in conjunction with each other or separately. The first one is the incentive to **rethink the concept of COMI** that is present in the Recast Insolvency Regulation in favor of the more straightforward principle of the "registered office" or the "place of incorporation". Some of the researchers in the relevant field suggest that the concept of COMI if rather vague in its nature and the adoption of the clear and straight concept of the registered office without a possibility of it to be rebutted will contribute to the creation of a clear and predictable system as well as reduce the information costs for third parties and the cost of capital for companies.[150] According to prof. Wolf-Georg Ringe, the implementation of the principle of the place of registration instead of the COMI principle "would yield coherence between the applicable insolvency law and company law so that problems that problems as the present one would disappear".[151]

The proposal supported by some scholars including prof. Ringe seems to be quite straightforward and precise. In theory, such approach, of course, will eliminate the problem of the collision between the principle of *lex societatis* and *lex concursus* in cases which involve a cross-border element. That being said, we should try to find a grounded, reasonable and suitable for all decision to this question. The practice of the EU's legislative proposals and history of the

[149] See section of the Master's Thesis – "The duties of companies' directors and the Recast Insolvency Regulation. The interrelation of the new EIR and the *Kornhaas v Dithmar case".*
[150] Wolf-Georg Ringe, "Kornhaas and the Challenge of Applying Keck in Establishment." *European Law Review*, no. 2, (2016), 277.
[151] Wolf-Georg Ringe, "Kornhaas and the Challenge of Applying Keck in Establishment." *European Law Review*, no. 2, (2016), 277.

Regulations in the field of insolvency law shows that the EU's authorities and the European Commission, in particular, are likely to preserve the concept of COMI. The draft proposals for the Recast Insolvency Regulation indicate that the COMI principle is embraced within the EU, gained some elaboration firstly in the case law and subsequently in the text of the New EIR. That is why it is highly unlikely that the attitude towards the principle of *centre of main interests* will experience some amendments.

Another possible solution to the problem of the interrelation between the provisions on the duties of companies' directors and their liability that are located under different "umbrellas" – the company law and insolvency law – would the i**nclusion of the explicit provision regarding the list of duties that are of insolvency law-nature** into the text of the Recast Insolvency Regulation. An inclusion of an explicit list of actions that derive directly from the insolvency proceedings and are closely linked with them into the text of the Recast Insolvency Regulation would definitely introduce a greater degree of legal certainty in the document itself, but the question on whether it should be an exhaustive or non-exhaustive list remains. Frankly speaking, it would be near to impossible to foresee everything and to put an exhaustive list in the text of the New EIR. On top of that, it is hard not to agree here with the opinion of prof. Lennarts who pointed out that in the case of the inclusion of the express list of actions that are connected with the insolvency proceedings would mean that the "lawmakers in Brussels need to pick up what CJEU refrained from doing in its *Kornhaas* judgment: to clearly define what the passage in italics means".[152] It is indeed hard to imagine the materialization of the proposed scenario of the inclusion of the list of actions that have their roots in the insolvency proceedings into the text of the Recast Insolvency Regulation.

Another viable recommendation for the improvement of the above-mentioned situation was developed and proposed by the researchers from Max Planck Institute and the University of Vienna in their work "The Implementation of the New Insolvency Regulation – Recommendations and Guidelines". In theory, it can become the one that is most likely to be used by the national courts as it proposes the **guide for the interpretation of the provisions of the Recast Insolvency Regulation** rather than stands for the implementation of the new wording of the relevant provisions. It, thus, becomes relatively easy to follow. The guide consists of the following recommendations: 1) The article 6(1) of the New EIR and its Recitals 16 and 35 provide us for the direction of thinking when assessing certain national action on the case-by-case basis. For example, article 6(1) contains the so-called "*Gourdain* formula"[153] that provides that the action

[152] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 129.
[153] "The Implementation of the New Insolvency Regulation – Recommendations and Guidelines." n.d. Max Planck Institute. http://insreg.mpi.lu/Guidelines.pdf. UST/2013/JCIV/AG/4679, 57.

based on the provision of the national law can determine applicable and falls under the jurisdiction of the court that is empowered to open the insolvency proceedings if and only if [cumulative condition] such action satisfies two criterions: a) it is an "insolvency related" one and b) it is "closely linked" with the insolvency proceedings.[154] The recitals 16 and 35 provide for the additional clarification and guidance on how to act.

The recommendations for the interpretation of such a "*Gourdain* formula" are then the following: in each particular case, the court should check the fulfillment of both of the criterions simultaneously. If one of them is not fulfilled – the action is not of an insolvency-nature. Further, an action deemed to be closely linked to insolvency proceedings if it is brought in the context of such proceedings and the action derives directly from insolvency proceedings when it finds its source in a provision which is not located in either the common rules, civil or commercial laws and it is specific to insolvency proceedings. In this regard, the controversial wording of Recital 16 is advised to be interpreted as not applicable to "insolvency related" actions.[155] In addition to that, while assessing the two above-mentioned criterions, it is proposed to pay close attention to whether an action serves an insolvency-specific purpose (meaning that the specific action was constructed by the legislator with the aim to protect the rights of general body of creditors by adjusting the general civil or company law rules for the situation of the vicinity of insolvency); whether it is efficient and effective for the commenced insolvency proceedings to apply the action that is under the assessment (*effet utile*) and finally, whether the international jurisdiction of the assessing court does not hamper the general jurisdiction interest (the protection of the defendant in this case).[156]

The proposal that has been just reviewed seems to have a good rationale behind it and thus a good perspective to be followed by the courts hearing the insolvency-related cases that involve a cross-border element. It does not require any amendments to the wording of the already adopted Recast Insolvency Regulation that is currently in force. What it does offer, is the way of interpretation of the already existing provisions. The cost of application of such a proposal is very low, that is why it highly likely that it will find its place in practice.

Another possible solution to the problem yet probably the hardest one to implement – is the **substantive harmonization** of laws within the European Union. This proposal has been on the horizon since the very appearance of the problems that we are discussing in this Master's Thesis. Various opinions have been already expressed on the topic at hand. And almost all of the

[154] Recast of the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, *Official Journal of the European Union*, *L 141/19*, *05/06/2015*, art. 6(1)
[155] "The Implementation of the New Insolvency Regulation – Recommendations and Guidelines." n.d. Max Planck Institute. http://insreg.mpi.lu/Guidelines.pdf. UST/2013/JCIV/AG/4679, 57.
[156] "The Implementation of the New Insolvency Regulation – Recommendations and Guidelines." n.d. Max Planck Institute. http://insreg.mpi.lu/Guidelines.pdf. UST/2013/JCIV/AG/4679, 57.

scholars whose field of research lies in the field of the harmonisation of the national company laws and insolvency laws pointed out that the despite the fact that full harmonization will indeed lead to the elimination of the problem of any collision between the laws, such full harmonization is neither possible, nor desirable.[157] The way of harmonization that is rather viable deals with the partial harmonization of the core directors' duties. One of such opinions was raised by prof. Lennarts who proposes to harmonize only the certain core duties of the companies' directors and only the duties that emerge in the vicinity of insolvency. The proposal presented by prof. Lennarts does not contain a suggestion to clearly elaborate a single EU-wide duty of the companies' directors to, for example, file for a commencement of the insolvency proceedings within a certain period of time after the company becomes insolvent, or the duty to refrain from making any preferential payments when the company is in the state of insolvency.[158] The author of the proposal rather suggests that any attempt at harmonization should at least provide an explicit clarification for:

- "***the point of time*** *when the* ***duty*** *to have regard to the pari passu rule* ***kicks in****;*
- *whether it* ***is possible for directors to justify a preferential payment*** *because it was made on the basis of a feasible restructuring plan;*
- *which* ***conditions a restructuring plan*** *used as a justification for making preferential payments* ***must meet***" [emphasis added].[159]

Speaking of all these incentives for the harmonisation of directors' duties within the European Union it is necessary to always keep in mind that knowing the fact that there are currently [April 2018] 28 Member States all of whom have their own legislative background and roots of either Common Law or Civil Law tradition, thus it is highly unlikely that any of the incentives aimed at harmonisation of the duties of directors will ever find enough of support within the EU. As we analysed in the general part of the current Master's Thesis, there are at least two directors' duties that appear when the company steps into the vicinity of insolvency and they are opposite to each other – the duty to cease any trading activity of the insolvent company and to file for the opening of the insolvency proceedings [the approach of various Civil Law countries] or the duty to refrain from conducting the so-called "wrongful trading" activity [Common Law countries' approach]. That is why the approach of creating a single bunch of EU-wide duties of companies' directors is not the one that will ever be chosen. Thus, in the opinion of the author of the Master's

[157] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 130.
[158] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 130.
[159] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 130.

Thesis, the approach that is proposed by prof. Lennarts could be more viable as it stands for the clarification of the guiding directions rather than the development of the precise EU-widely acknowledged duties of directors.

Finally, the research conducted by the author of the Master's Thesis by means of sending a questionnaire to various law firms across the European Union has showed that most of the practitioners do recognize the necessity of the proper harmonization of the field of duties of companies' directors in order to avoid situations that are similar to that described above in the second hypothetical scenario.[160] Some of the practitioners, from Austria for example, stand for the necessity to implement an express provision regarding the duties of companies' directors in the vicinity of insolvency. A form of Directive is deemed to be the most effective tool to achieve that result as it is not so strict as a Regulation and provides for the certain degree of freedom for the EU Member-states on the implementation of such provision in their national laws, yet it will eliminate the problem of the conflict of laws based on the principles of *lex societatis* and *lex concursus* as the relevant provision will certainly belong to the bunch of national insolvency laws. Some of the reporters mentioned the "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"[161] as a desirable tool to be implemented.

In summary, the analysis of the possible ways of improvement of the current situation with the lack of legal certainty in respect of the applicability of the national laws that contains provisions on the duties of directors in cases which involve a cross-border element showed that there is no "jack of all trades" solution that would bring total clarity to the problem at hand. Any of the five proposals indicated above do not solve all the questions: some of the proposals are good in theory, but not likely to be implemented any time soon [the abundance of the COMI concept], others are in overall good but very difficult to adopt [the full harmonisation of the laws on the duties of directors] etc.

[160] Loes Lennarts, "Directors in the Twilight Zone – Kornhaas and 'Beyond' Some Observations from a Dutch Perspective." *Harmonisation of European Insolvency Law*. INSOL Europe (2016), 128.

[161] "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." n.d. European Commission. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016PC0723. COM/2016/0723 final - 2016/0359 (COD) Strasbourg, 22.11.2016, art. 18

CONCLUSIONS AND RECOMMENDATIONS

Conclusions. One of the aims of the current Master's Thesis was to analyse and propose the solutions to quite a specific yet important problematic that hampers the state of convergence within the European Union – the problem related to the legal uncertainty in the field of duties of companies' directors that might occur in cases of insolvency of the company that involves a cross-border element.

The **comparative analysis** of the experience of different EU Member-states in respect of the problem of the existing legal uncertainty has led the author of the Thesis to the **following conclusions**:

1. The examples of the compared national jurisdictions (Germany, the United Kingdom, Lithuania, Slovenia etc.) has showed us that there is indeed a tendency among the EU Member States to locate the provisions regarding the duties of companies' directors in different sets of laws: company/corporate laws or insolvency laws (depending on the duty);
2. **The problem** with the legal uncertainty in the relevant field that could hamper the convergence within the European Union **does exist** and manifests itself in the situation of the complications that national courts of the EU Member States experience with regards of the precise national law provisions that need to be applicable in cases that involve a cross-border element;
3. The Master's Thesis's **defended statement No 1 is proved**: "*The use of the international private law rules in regards to the determination of the applicable law and rules laid down in the Recast Insolvency Regulation can create legal uncertainty in respect of the applicable law on the director's duties*.";
4. The Master's Thesis's **defended statement No 2 is proved**: "*The existing solutions to such legal uncertainty problem that are contained in the existing case law and the Recast Insolvency Regulation are not efficient enough and require further consideration*".

Recommendations. Taking this situation into consideration, in Thesis's author's opinion, the following solutions might become handy when we are talking about the reduction of the legal uncertainty in the discussed field:

1) to embrace the rules of interpretation of the so-called "*Gourdain* formula"[162] of the article 6 of the Recast Insolvency Regulation, as it was described earlier in the Thesis [the proposal that is provided by the Max Planck Institute in its "The Implementation of the New Insolvency Regulation – Recommendations and Guidelines"]. The interpretation of the provisions of the article 6 should be conducted in conjunction with the guides of the Recitals 16 and 35 of the New EIR;
2) to bring into force the "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" the text of Proposal for which was already developed by the European Commission;
3) while deciding on the final text of chapter 5, article 18 of the Directive on preventive restructuring frameworks, take into consideration the opinion of the Economic and Social Committee on the content of the article 18. To set forth the provisions of the Article 18 in the following way:

"*Article 18*

Duties of directors

1. *Member States shall lay down rules to ensure that, where there is a likelihood of insolvency, directors have the following obligations:*
   (a) to take immediate steps to minimize the loss for creditors, employees, 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.[163]
2. *In the process of performance of the duties indicated in paragraph 1, directors have to ensure the company assets not to deplete below the level necessary to pay accrued commitments to employees*".[164]

[162] "The Implementation of the New Insolvency Regulation – Recommendations and Guidelines." n.d. Max Planck Institute. http://insreg.mpi.lu/Guidelines.pdf. UST/2013/JCIV/AG/4679, 57.
[163] "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." n.d. European Commission. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016PC0723. COM/2016/0723 final - 2016/0359 (COD) Strasbourg, 22.11.2016, art. 18
[164] "Opinion of the Economic and Social Committee on the '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' ." n.d. *Official Journal of*

The above-mentioned options, in the Thesis's author's opinion, can provide can make their small but important contribution to the efforts made by the scholars, practitioners and other researchers of the relevant field aimed at reduction of the state of legal uncertainty in respect of the existing regulations in the sphere of duties of companies' directors. There are not so many obstacles to circumvent in order to implement the mentioned proposals as some of them are related to the interpretation of the provisions that already exist while others require the adoption of the legal act, the draft of which is already prepared by the European Commission.

the European Union, C 209/21, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016AE6275. (COM (2016) 723 final — 2016/0359 (COD)), paragraph 4.3.12

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ANNOTATION

The topic of the Master's Thesis: "The Duties and Liabilities of Company Directors in Insolvency Proceedings: a Comparative Analysis".

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The Master's Thesis is devoted to the analysis of the problematic issue regarding the legal uncertainty within the EU in respect of the applicable national substantive law on the duties and liabilities of companies' directors in insolvency proceedings that involve a cross-border element. The comparative analysis of the national company and insolvency legislation of various EU Member-states is given. The main focus of the Thesis is on the existing case law on the issue at hand of the Court of Justice of the European Union, mainly the *Kornhaas v Dithmar case* and the Recast of the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings and the effectiveness of the mentioned case law and the normative act in solving the problem of the legal uncertainty at hand.

Keywords: *duties of directors in the vicinity of insolvency; legal uncertainty regarding the applicable law on the duties of directors; Kornhaas v Dithmar; Recast Insolvency Regulation.*

SUMMARY

THE DUTIES AND LIABILITIES OF COMPANY DIRECTORS IN INSOLVENCY PROCEEDINGS: A COMPARATIVE ANALYSIS

Yevhen Shcherbyna

The core problematic issue of the Thesis is the existing legal uncertainty in respect of the substantive law that is applicable in cases of insolvency of the company that has a cross-border element. The main purpose of the Thesis is to analyze the possible solutions to the problem at hand and to propose the most suitable and vital changes to the existing legal regulations of the relevant sphere that could reduce if not eliminate the problem.

In order to identify and subsequently to prove or deny the existence of the mentioned problem, the following line of thinking was adopted: first, as a starting point, there was a necessity to identify those core duties that the directors of the companies are obliged to obey when the company is financially sound *i.e.* solvent. We were able to see that there is indeed the general state of uniformity among the EU Member-states when we are talking about such duties of directors like the duty of care and the duty loyalty. What was also emphasized, is the fact that the general tendency for the location of the main duties of companies' directors are similar among the European jurisdictions – such duties are located mainly under the "umbrella" of either national company law or commercial/ civil law with a minority of EU Member-states (usually among the Common Law countries) providing for the regulation of the duties of directors through the national case law. Second, it was identified, that the majority of the EU Member-states opted to provide for the changes in the scope and/or nature of the duties of directors as the company approaches the vicinity of insolvency. Usually, such changes lead to the emergence of one of the two new duties, either the duty to cease trading of the insolvent company and to file for the commencement of the insolvency proceedings [Civil Law countries] or the duty to refrain from conducting the so-called "wrongful trading" activity [Common Law countries]. Here it is the moment when the prerequisite for the future legal uncertainty comes into play: the various examples of the national approaches have indicated that some of the EU Member-states provide for the new "insolvency-related" duties to be located under the "umbrella" of insolvency law while some others provide them to be a part of the company or civil or even tort law.

The main problem of the Master's Thesis has been identified: the situation when we have a company that is registered in one EU Member-state but moved its COMI to the other (and subsequently became insolvent there) the legal uncertainty appears as to what national law on the duties and liabilities of the companies' directors should the national court, that is empowered to hear the case, apply? This usually the case as the rules of international private law provide for the national company law to be applicable of the basis of the *lex societatis* [the place of the registration

of the company], while the insolvency law that is applicable is determined on the basis of the *lex concursus* [the national law of the court that is empowered to hear the case]. The importance of the issue at hand is reiterated by the several hypotheticals which describe what could happen if not to solve the problem of the legal uncertainty in the current field.

The problem has become so significant that the Court of Justice of the European Union had to intervene with its preliminary ruling in *Kornhaas v Dithmar case* – a landmark case in this sphere. The further analysis of the reaction of the practitioners and scholars has shown that the CJEU's preliminary ruling has lots of deficiencies and cannot serve as a template for all of the EU Member-states. Again the hypotheticals based on the Dutch experience prove that.

Further on, both the old Insolvency Regulation as well as the provisions on the applicable law of the Recast Insolvency Regulation were analyzed in order to find whether the New EIR provides for the solution of the problem at hand. While some of the practitioners and scholars are of opinion that the conundrum of this problem was reduced by the adoption of the Recast Insolvency Regulation, many others argue that the situation is still controversial and that the text of the New EIR on the issue at hand is rather ambiguous. And the further elaboration on the topic is necessary.

As a result, both of the Thesis's defended statements were proved: firstly, it was shown that the problem of the legal uncertainty in the field at hand does exist and secondly, the necessity for the amendments and further elaboration of the existing case law and provisions of the Recast Insolvency Regulation was justified.

Finally, numerous proposals for the solution to the problem of the legal uncertainty in the relevant field were described and analyzed and the current Master's Thesis author's opinion on the viability of the mentioned solutions was expressed.

ANNEX No. 1

Form approved on 20 November 2012 by the decision No. 1SN 10 of the Senate of Mykolas Romeris University

HONESTY DECLARATION

15/05/2018

Vilnius

I, **Yevhen Shcherbyna**, a student of

Mykolas Romeris University (hereinafter referred to University), Faculty of law, European and International Business Law,

confirm that the Master's Thesis titled

"The duties and liabilities of company directors in insolvency proceedings: a comparative analysis"

1. Is carried out independently and honestly;
2. Was not presented and defended in another educational institution in Lithuania or abroad;
3. Was written in respect of the academic integrity and after becoming acquainted with methodological guidelines for thesis preparation.

I am informed of the fact that student can be expelled from the University for the breach of the fair competition principle, plagiarism, corresponding to the breach of the academic ethics.

Yevhen Shcherbyna

(*Signature*) (*Name, Surname*)

Master's Thesis finished 2015-05-16, Yevhen Shcherbyna

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