Chronicle directors' liability - manifestly improper management (part 3)

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1. Introduction

The management board is responsible for the day-to-day management of the company and determining its policy. The manner in which the management board has performed its duties may result in the company and or one or more of its creditors suffering damages. In that case, the question arises whether a director can be personally liable to compensate the company and or one or more of its creditors for the damages suffered.

In this chronicle, I will discuss judgments by Dutch courts on the personal liability of directors, rendered in the period from January 2022 to May 2023.

In the first part of this chronicle, I discussed judgments addressing the question of whether a director is personally liable for the company's damages due to improper performance of management duties. In the second part of this chronicle, I discussed judgments addressing the question whether a director is personally liable in tort for the damages suffered by the creditors of the company. Finally, in this third part of this chronicle, I will discuss judgments addressing the question of whether a director is personally liable for the deficit in the company's bankruptcy estate due to manifestly improper management.

2. Manifestly improper management

2.1. Introduction

In the event of the company's bankruptcy, each director is jointly and severally liable to the bankruptcy estate for the deficit in the bankruptcy estate if the management board has manifestly improperly performed its management duties in the period of three years prior to the bankruptcy and it is plausible that this was a major cause of the

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bankruptcy. Legal action for payment of the deficit in the bankruptcy estate can be brought by the company's bankruptcy trustee.

Manifestly improper management can only be said to have occurred if no reasonably thinking director would have acted in this way under the same circumstances. The question whether the management board did not perform its management duties properly must be judged on the basis of what the management board foresaw or could have foreseen at the time it performed its duties. Here, the intention is not to punish directors for unintentional stupidity and policy errors. The word 'manifestly' expresses that only an obvious, so to speak, undoubtedly impropriety in the performance of management duties should be taken into account. The directors must have acted with the (objective) knowledge that the company's creditors will be prejudiced.

2.2. Relaunching a business out of bankruptcy

In proceedings in which the Court of Appeal of Den Bosch ruled on 6 December 2022, two directors had

bought the assets of a bankrupt company. They then restarted the business associated with these assets in two companies. These two companies were declared bankrupt barely two years after the restart. The bankruptcy trustee accused the directors of manifestly improperly performing their management duties because they carried out the restart of the business without sufficient financing given the foreseeable financing need of the business.

According to the court, it must first be determined whether a liquidity shortage and thus a financing need was foreseeable for the directors at the start of the relaunch. Based on a cash flow statement prepared by the directors at the time, the court ruled that with a supplier payment term of 60 days at the start of the relaunch, a significant liquidity shortage and therefore a significant financing need of the business was foreseeable for the directors.

The court then ruled that at the start of the relaunch, the directors were not entitled to assume that the financing need of the business was or could be met, because at the start of the relaunch, they had not made any agreements with suppliers on a longer payment term than 60 days. Nor had they made it clear with how many and which suppliers they had subsequently made agreements with on longer payment terms. Let alone what the content of the agreements was and how structural these agreements were. The fact that suppliers in practice did not strictly adhere to applicable payment terms and accepted later or staggered payments was, according to the court, not sufficient to meet the financing need of the business given the size and structural nature of the expected liquidity shortage. The companies could not enforce these later or staggered payments.

According to the directors, the financing need of the business could be met because the companies were financed on current account by group companies. The court dismissed this argument, as there was no intra-group current account credit facility that could be called upon at will by the companies. What happened in practice was that group companies

sometimes advanced payments for the companies to the extent that they themselves had sufficient liquidity. According to the court, this practice did not provide sufficient certainty and continuity and was therefore not sufficient as a solution to meet the anticipated extensive and structural liquidity shortage.

In light of the above, the court ruled that no financing was available at the start of the relaunch, nor were the directors entitled to rely on such financing becoming available shortly thereafter. This means, according to the court, that the directors entered into obligations of which it was certain that the companies could not fulfill these. The companies were dependent on the willingness of suppliers to deviate from the applicable payment terms, the benevolence of group companies and the availability of liquidity at these group companies. This while the market in which the companies operated was facing a weak economic tide, shrinking demand and rising procurement costs and VAT at the start of the relaunch. In these circumstances no reasonable thinking director would have carried out the relaunch, according to the court. Therefore, the directors have manifestly improperly performed their management duties and are in principle liable for the bankruptcy estate deficit.

2.3. De facto director

The person who has determined or co-determined the policy of a company, as if he were a director, may also be liable for the deficit in the bankruptcy estate if the management board has manifestly improperly performed its management duties in the three-year period preceding the bankruptcy and it is plausible that this is a major cause of the bankruptcy.

In a ruling on 24 March 2023, the Dutch Supreme Court ruled that a de facto director does not have to have managed the company instead of and with the exclusion of the formal management board in order to qualify as a de facto director. It is sufficient that a de facto director has at least appropriated part of the management powers and in that manner has determined or co-determined the policy as if he were a director. According to the Dutch Supreme Court, it can be inferred from the word 'co-determination' that such a determination of the policy by a

de facto director can also exist in the situation that, in addition, one or more formal directors continue to perform their duties as a director of the company.

2.4. Collective mitigation of liability for the deficit in the bankruptcy estate

A court may reduce the amount for which all the directors are liable if it considers it excessive, given the nature and seriousness of the improper performance of duties by the management board, the other causes of the bankruptcy, and also the manner in which the bankruptcy was settled.

On 13 May 2022, the Dutch Supreme Court ruled that these collective mitigation grounds are exhaustive. Therefore, a court may not reduce the amount for which all directors are liable based on any other mitigation grounds.

In proceedings in which the Dutch Supreme Court ruled on 21 April 2023, it was required to rule on how the court of appeal had mitigated the liability of all of the directors for the bankruptcy deficit.

> *Determination of the policy of a de facto director can also exist in the situation that, in addition, one or more formal directors continue to perform their duties as a director of the company.*

In the appeal proceedings, the court of appeal had ruled that the directors of a group of companies had been neglecting essential parts of their management duties for quite some time, when in fact the deteriorating financial situation of the companies called for alertness and intervention. Meanwhile, the directors had carried out a restructuring of the group of companies, which resulted in all assets and benefits of the companies ending up in other companies affiliated to the directors. As a result, the liquidity, solvency and financial resilience of the companies had further deteriorated at a critical time. The court of appeal found the directors' actions seriously culpable. Nevertheless, taking all circumstances into account – including the directors' in itself low remuneration, the lack of concrete indications that the directors had enriched themselves and the limited profitability of the companies' business – the court of appeal mitigated the liability of the directors to only 10% of the bankruptcy estate deficit.

It may come as no surprise that the Dutch Supreme Court annulled the court of appeal's mitigation judgment in view of its ruling of 13 May 2022. The statutory collective mitigation grounds are exhaustive. Therefore, the court of appeal could not base its mitigation judgment on all the circumstances of the case. Also, "the low remuneration of the directors" does not fall under one of the collective mitigation grounds. Furthermore, the Dutch Supreme Court found the court of appeal's mitigation judgment incomprehensible in view of the court of appeal's opinion that (a) the organisation was not "in control", as a result of which timely and adequate action had not been taken, (b) a restructuring had been carried out precisely in that dire financial situation, the result of which was that assets or benefits had ended up in other companies affiliated to the directors, and (c) that the directors had therefore acted seriously culpable. In that event it is not obvious to mitigate the liability of the directors. The Dutch Supreme Court also found it incomprehensible that the court of appeal ruled that there were no concrete indications that the directors had personally enriched themselves. According to the Dutch Supreme Court, unjust enrichment may also occur if directors indirectly enjoy personal benefits through a corporate structure, as had

occurred in this case.

Finally, the Dutch Supreme Court ruled that mitigation is not only possible in cases where the deficit in the bankruptcy estate exceeds the damage caused by the mismanagement. The parliamentary history shows that the basis for the power of mitigation is, among other things, that it is not reasonable to hold the directors liable for a higher amount than the damage that may have been caused by the mismanagement, and also that the court may reduce the amount the directors have to pay so that it is in reasonable proportion to the nature and seriousness of their shortcomings. Hereby also the share of the mismanagement in the total causes of the bankruptcy and the way in which the bankruptcy was settled, should be taken into consideration. This leaves room for mitigation even if the bankruptcy estate deficit does not exceed the damage caused by the improper performance of management duties, without that room being limited to cases where special circumstances arise.

In the Den Bosch court of appeal's decision of 6 December 2022 on the restart of a company without sufficient financing, the court mitigated the liability of the directors to 25% of the deficit in the bankruptcy estate, because market conditions were also a major cause of the bankruptcy. Bank analyses showed that the market in which the bankrupt companies operated was facing a weak economic tide, shrinking demand and rising procurement costs and VAT. Because of these circumstances, according to the court, there was a high probability that the companies would also have failed if the directors had met the financing needs at the start of the company's relaunch. In addition, the court considers it important that it had not been shown that the directors had personally enriched themselves.

2.5. Individual mitigation of liability estate deficit

The court can also mitigate the amount of liability of an individual director if it deems this excessive in view of the time during which that director held office during the period in which the manifest improper performance of management duties took place.

In proceedings in which the Overijssel District Court ruled on 23 February 2023, a director could not invoke this individual mitigation ground because he had remained in office as a director until relatively shortly before the bankruptcy. The question then arose whether the court was still allowed to mitigate the liability of the director for the deficit in the bankruptcy estate on the basis of a general statutory mitigation ground pursuant to which liability may be mitigated if an order to pay the full amount would lead to unacceptable consequences.

The court answered this question in the affirmative despite the fact that the statutory collective and individual grounds for mitigation are exhaustive. According to the court, it cannot be deduced from the parliamentary history that the legislator intended that directors who are liable for the bankruptcy estate deficit are deprived of the protection against unacceptable outcomes that the general statutory mitigation ground intends to provide for exceptional cases. In this case, the liability of the director for the entire bankruptcy estate deficit was unacceptable, according to the court, because the director had already ceased to be involved in the company's management due to serious illness well before the bankruptcy. He had asked another person to take over the management of the company and was wrongly under the impression that the other person had deregistered him as a director. Further, the 78-year-old director's retirement provision had gone up in smoke as a result of the bankruptcy and, finally, the director had made substantial loans to the company. The court therefore mitigated liability of this director to 50% of the bankruptcy estate deficit.

3. In conclusion

In the third part of this chronicle, I discussed rulings on the personal liability of directors for manifestly improper management. This covered the personal liability of directors in case of a relaunch of a business out of a bankruptcy without covering the financing needs, the personal liability of de facto policymakers and the collective and individual mitigation of liability for the deficit in the bankruptcy estate by a Dutch court.

Should you have any questions about directors' liability, please contact René van de Klift.

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