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## *The Risk Liability for Company Directors in French Insolvencies*

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# **The Risk of Liability for Company Directors in French Insolvencies**

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## **Introduction**

The notion that management may be liable for mistakes which lead to damage occurring to the companies in their care is well known in Western European legislation and jurisprudence. Some jurisdictions require disqualification of directors from further office where their acts lead to irreparable consequences for their firm and as a measure of public protection. Other systems are keen to ensure that liability leads to financial contributions, with view to repairing some of the damage caused by compensating those directly affected by the wrongful act. This is the situation in France, where a developed notion of liability is the subject of the Law on Insolvency.<sup>1</sup> There are three titles which operate. Two refer to civil liability for acts related to the management of companies. Title V is headed: 'Particular Provisions applicable to Private-Law Bodies and their Directors',<sup>2</sup> while Title VI is headed: 'Personal Bankruptcy'.<sup>3</sup> Title VII deals with criminal penalties and acts amounting to offences and is headed 'Criminal Bankruptcy and other Offences'.<sup>4</sup>

## **Preliminary Points**

The regime which applies in insolvency is very much distinct from the penalties and punishments which apply in general company law, particularly to the offences and misdemeanours codified in the Companies Law of 1966. This distinction is maintained by the provision that liability for company debt and consequent penalties fall to be governed by insolvency legislation once insolvency proceedings have been opened in respect of the company concerned.<sup>5</sup> Specific provision is also made for transferring jurisdiction from ordinary company law to insolvency law in the case of directors and officers upon insolvency proceedings being triggered.<sup>6</sup>

This distinction, avoiding as it does traditional remedies for aggrieved parties, such as the action sociale, is the subject for much debate and criticism, as it leaves action largely to the institutions that control insolvency proceedings, thus reducing the ability of creditors to take action.<sup>7</sup> This distinction is confirmed in

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<sup>1</sup>Law no. 85-98 of 25 January 1985 ('Law of 1985'), implemented by Decree No. 85-1388 of 21 December 1985. References below to Articles of a law ('L. Art.') or decree ('D. Art.') will be to this law and decree.

<sup>2</sup>'Dispositions particulières aux personnes morales et à leurs dirigeants' (L. Arts. 178 to 184).

<sup>3</sup>'Faillite personnelle et autres mesures d'interdiction' (L. Arts. 185 to 195).

<sup>4</sup>'Banqueroute et autres infractions' (L. Arts. 196 to 209).

<sup>5</sup>Article 248, Law no. 66-537 of 24 July 1966.

<sup>6</sup>Article 249, Law no. 66-537 of 24 July 1966.

<sup>7</sup>See La Responsabilite des dirigeants d'une personne morale en cas de redressement ou de liquidation judiciaire: une evolution jurisprudentielle preoccupante, Soinne B. Les Petites

the case-law, which states that a suit intended to hold the manager of a company personally liable under Article 52 of the Company Law was incompatible with proceedings begun under the relevant articles of the Law of 1985.<sup>8</sup> Nevertheless, criminal offences, contained within the Law of 1985, remain the province of the criminal courts.

### **The Definition of Insolvency**

When a company has reached the stage where it becomes unable to pay its debt,<sup>9</sup> it has only 15 days in which to make a formal declaration of insolvency to the court.<sup>10</sup> The directors may be held personally liable for all or part of the debt if the company continues to trade without a declaration. The court may decide when a company becomes technically insolvent at which point the 15-day deadline runs. A court is at liberty to fix the date when the company entered insolvency at up to eighteen months before the date of the judgment opening insolvency proceedings.<sup>11</sup> A court is not bound by this date when it makes a ruling finding liability on the part of a company director.<sup>12</sup> A court need not consider whether a director had any valid reasons for delaying a declaration once it has established a date when insolvency was entered.<sup>13</sup> A criminal court is similarly not bound by any finding of the civil jurisdiction if a prosecution is brought in these courts relating to the insolvency.<sup>14</sup>

### **The Definition of Director**

The definition of director includes the titular President of the company, Chief and Deputy Executive Managers, members of the board and other managers and officers. If the company is permitted by the court to trade during insolvency proceedings, this definition also includes the administrator and the liquidator. The definition covers both appointed directors,<sup>15</sup> whose status derives from formal appointment or election by the appropriate body in accordance with the constitutional documents of the company, and shadow directors.<sup>16</sup>

### **Appointed Directors**

A director who leaves the company before the date of the insolvency judgment may not necessarily escape liability. The Cour de Cassation has ruled that if the cash-flow problems, leading to the insolvency of the company, existed while the

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Affiches 2 August 1995 No 92, p. 10 and La responsabilité civile du dirigeant en cas de redressement judiciaire, Campana M-J, Les Petites Affiches 20 April 1994 No. 47, p. 11.

<sup>8</sup>Cassation commerciale, 28 February 1995, Les Petites Affiches 28 June 1995 No. 77, p. 24 and Cassation commerciale, 6 December 1994, Les Petites Affiches 11 August 1995 No. 96, p. 37.

<sup>9</sup>'Cessation de paiements' is defined in L. Art. 3 as 'the inability to settle those debts which are due with the available assets'.

<sup>10</sup>'Déclaration de cessation des paiements'.

<sup>11</sup>L. Art. 9.

<sup>12</sup>Cassation commerciale, 30 November 1993, RJDA 94-4, no. 460.

<sup>13</sup>Cassation commerciale, 10 October 1995, RJDA 96-1, no. 136.

<sup>14</sup>Cassation criminelle, 21 June 1993, Les Petites Affiches 26 January 1994 No. 11, p. 20.

<sup>15</sup>Dirigeant de droit.

<sup>16</sup>Dirigeant de fait.

departed director was still in office and were known to him, he may be held liable for mismanagement.<sup>17</sup> Another decision of the court has held that an appointed director can not exculpate himself by suing the shadow director for a contribution to the debts of the company.<sup>18</sup> Similarly, an appointed director may not evade responsibility by presenting as his defence the fact that he had abandoned his duties to a shadow director.<sup>19</sup>

Other parties may also be treated as directors, including creditors and banks, due to the close relationship that may develop through the supply of goods and credit. It is not unknown for a banker to act as a *de jure* director,<sup>20</sup> appointed under the company's articles of association, with the consequence that he may be liable for acts committed during his period of office.<sup>21</sup> It is not known whether the practice is common in France, but the commentators state that the Law of 1985, having relaxed the automatic presumptions of causation and liability in previous insolvency legislation, is far more favourable to the appointment of bankers to directorships.<sup>22</sup>

### **Shadow Directors**

A person enjoys the status of a shadow director where he exercises the powers of an director to the extent that he is able to make financial and commercial decisions which bind the company.<sup>23</sup> This may occur where he exercises the powers of an director regularly or in his absence or where he represents to third parties that he is a company director, or where he exercises influence on the directors so that they act in accordance with his instructions. A court has held that a majority shareholder and founder of a company who represented himself to third parties as a director by placing orders and signing deliveries where no other employees had these powers was to be regarded as a shadow director.<sup>24</sup> No presumption of *de facto* status could, however, attach to the help given by a director's spouse who occasionally intervened in the running of the company.<sup>25</sup>

A company which satisfies the above conditions may be considered to have the status of a shadow director, in which case the representative of that company on the board of the insolvent company may be held jointly and severally liable with the company itself for the debts of the insolvent company.<sup>26</sup> A holding or mother company may be considered to exercise the role of a shadow director in one of its subsidiaries if it plays an important role in management decisions.<sup>27</sup> A mother company may also be held liable where both companies give the

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<sup>17</sup>Cassation commerciale, 13 December 1982, Bull Civ. IV.408, at 341.

<sup>18</sup>Cassation commerciale, 6 June 1995 no. 1178P Le quotidien juridique 95-62 at 2.

<sup>19</sup>Cassation commerciale, 9 May 1995 no. 1001P Le quotidien juridique 95-53 at 2.

<sup>20</sup>Dirigeant de droit.

<sup>21</sup>Cassation commerciale, 24 January 1983, RJ Com. 1984.215.

<sup>22</sup>Lamy droit du financement (1995) no. 2678.

<sup>23</sup>Dirigeant de fait.

<sup>24</sup>CA Versailles, 20 January 1994, RJDA 94-4 no. 461.

<sup>25</sup>CA Paris, 19 September 1995, BRDA 95-20 at 12.

<sup>26</sup>TC Paris, 5 January 1994, RJDA 94-4, no.456.

<sup>27</sup>CA Aix-en-Provence, 26 May 1981, D. 1983, IR, at 60.

appearance of being interdependent and under the same management.<sup>28</sup> Identity of management and pursuit of common aims or commercial activity are key factors in assessing the reality of separate company identity. The question of fictional companies and common purpose has also been the subject of much case-law and debate on the circumstances in which piercing the corporate veil is permitted.<sup>29</sup> Companies which share a common manager may find that insolvency proceedings involving one company may be extended to all companies thus associated.<sup>30</sup> If a company and a creditor, including a bank, share one or more directors, there may be a question of whether the personal link is strong enough to have influenced the company's decisions.

### **Restrictions during Insolvency**

Appointed and shadow directors of insolvent companies under judicial administration may also suffer removal from office and restrictions on transactions involving shares held in the insolvent company. A court may order the replacement of any director if it views this step as being necessary for the survival of the company.<sup>31</sup> The removal from office is not necessarily a sanction for errors committed previously by the director concerned, but may be a measure of safety to ensure the viability of the company. In addition, a court may order that voting rights attached to shares be exercised by a nominee of the court (usually the administrator) in the interests of the company. The court may also order part or all of the shares to be transferred to a third party at a price to be fixed by a court-appointed expert.<sup>32</sup> From the date of the declaration of insolvency, shares held by company directors in the company may not be transferred or otherwise dealt with without the approval of the court.<sup>33</sup>

### **Civil Liability Provisions**

#### **Personal Subjection to Insolvency Proceedings**

Company directors may be the subject of an action for personal liability where the company is insolvent and its assets are insufficient to repay the debts of the company. An essential prerequisite is that the company is first placed under judicial administration or is in liquidation.<sup>34</sup> The action may be brought by the administrator, creditors' representative, liquidator or the public prosecutor. Proceedings may also be opened by the court itself, with the court acting simultaneously as both plaintiff and judge.<sup>35</sup> When the debtor company is the subject of judicial administration or liquidation, creditors may not institute personal liability actions against the company directors.<sup>36</sup> Any decision by those

<sup>28</sup>Cassation commerciale, 18 October 1994, no.1951D, Mémento des Sociétés Commerciales no. 3396.

<sup>29</sup>See Identite ou diversite des notions de fictivite et de confusion des patrimoines, Soinne B., Les Petites Affiches 6 December 1995 No. 146, p. 12.

<sup>30</sup>Cassation commerciale, 8 February 1994, Les Petites Affiches 24 May 1995 No. 62, p. 33.

<sup>31</sup>L. Art. 23.

<sup>32</sup>L. Art. 23 al. 2.

<sup>33</sup>L. Art. 28.

<sup>34</sup>L. Art. 179.

<sup>35</sup>L. Art. 183.

<sup>36</sup>CA Paris, 10 July 1987, RPC.1988.437.

individuals authorised by law to take action not to do so will deprive creditors of their right to pursue directors for the repayment of debt.

The court has a wide discretion to investigate an alleged offence and may permit the supervising judge or another member of the court to have access to any records tending to show the financial situation of the directors in question. This information may be obtained, notwithstanding any other legal provision to the contrary, from public bodies, credit and lending institutions, insurance companies or social security offices in order to enable the court to assess the financial resources of the director available to meet any judgment.<sup>37</sup>

The sole criterion for application of the law is that the insolvency proceedings in respect of the company have revealed a deficiency in the assets to which the director is found to have contributed.<sup>38</sup> In addition, the directors of an insolvent company which is under judicial administration will also be subject to judicial administration where they have failed to discharge their liability for contributions to the repayment of the company's debts.<sup>39</sup> The same applies in situations where they have used the company's assets as their own, used the company to carry out their personal business, used the company's assets or credit for personal gain contrary to the company's interest or for the benefit of another company in which they have a direct or indirect interest, conducted the business of the company in an abusive manner for personal gain, resulting in the insolvency of the company, destroyed, falsified or failed to keep proper accounts or misappropriated or concealed company assets or fraudulently increased the company's debts.<sup>40</sup>

It must be proven generally that the director in question was guilty of mismanagement which caused the loss of assets that contributed to the company being unable to meet its debts. The liability of company directors must be shown by a causal link between the act of mismanagement and the debt which arises.<sup>41</sup> It is not necessary to prove a direct link between a specific act and the damage which results.<sup>42</sup> It need not be the main or only cause. The concept of mismanagement is left undefined in the law and courts have therefore had to decide on a definition of mismanagement on a case to case basis.

The most common findings of mismanagement have been where company directors have allowed the company to trade while manifestly insolvent, have embarked on projects beyond the company's financial capacity and which were not in its best interests,<sup>43</sup> have engaged the company in transactions, neither at arm's length nor of a commercial nature and have improperly extended credit

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<sup>37</sup>L. Art. 184.

<sup>38</sup>L. Art. 180 al. 1.

<sup>39</sup>L. Art. 181.

<sup>40</sup>L. Art. 182.

<sup>41</sup>Cannu et al., *Entreprises en Difficulté*, Joly, 1994, no.1652.

<sup>42</sup>L. Art. 180 al. 1.

<sup>43</sup>CA Aix-en-Provence, 9 December 1993, D.95.33.475.

beyond the company's means, relying simply on the banks to meet the company's cash flow needs.<sup>44</sup>

A court may fix the proportion in which directors may be liable to contribute. A court is not required to consider whether or not the director in question was remunerated for his services nor whether any internal arrangements existed to indemnify directors against liability. The maximum liability that may be imposed by a court is the difference between available assets and the sum necessary to meet its debts, regardless of whether or not the director in question was entirely responsible for the debt occurring.<sup>45</sup> Company directors are at liberty to institute civil proceedings against any third parties who may have contributed to or occasioned the loss being suffered, provided they have already satisfied the judgment of the court imposing personal liability. They may not, however, institute proceedings against their fellow directors for contributions.<sup>46</sup>

Any action must be brought within 3 years of the judgment of the court which approves the recovery plan for the company or orders that the company be placed in liquidation.<sup>47</sup> The amounts paid by the directors held personally liable for the company's debts are applied to either the reduction of the company's debts in accordance with the recovery plan or, in the case of a liquidation, the payment of creditors in accordance with their statutory ranking.<sup>48</sup> The procedure for the judicial administration of the directors of an insolvent company is similar to that applied to the company itself. The business affairs of the director will be examined and any suspect transactions during the period of relation back will be open to question. A judgment which finds that an director is personally liable for mismanagement may be enforced directly against the assets of an director. The order is directly enforceable and may be executed immediately, subject to suspension on application to the President of the Court of Appeal, who must be satisfied there exist good grounds for ordering a stay of execution.<sup>49</sup>

### **Personal Bankruptcy of Company Directors**

At any time during insolvency proceedings, the imposition of personal bankruptcy is also an option open to the court. This rule applies to all commercial persons, all persons who directly or indirectly, as an appointed director or acting as a shadow director, managed or liquidated a private-law body which carried out business activities as well as to representatives of other entities which acted as directors of the subsidiary body.<sup>50</sup> The consequences of personal bankruptcy include a prohibition against managing any commercial enterprise.<sup>51</sup> The right to petition for the bankruptcy of a company director is

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<sup>44</sup>Cassation commerciale, 9 May 1995, Dict. Perm. des Diff. des Entreprises, Bulletin 138. 243, p. 7339.

<sup>45</sup>Cassation commerciale, 30 November 1993, Bull. Civ. IV No. 440.

<sup>46</sup>Cassation commerciale, 6 June 1995, RJDA 95-7, no. 903.

<sup>47</sup>L. Art. 180 al. 2.

<sup>48</sup>L. Art. 180 al. 3.

<sup>49</sup>L. Art. 155.

<sup>50</sup>L. Art. 185.

<sup>51</sup>L. Art. 186.

limited to the administrator, liquidator, creditor' representative and the public prosecutor. A court may also initiate personal bankruptcy proceedings of its own motion.<sup>52</sup>

Persons considered directors of an insolvent company may be declared bankrupt where extension of judicial administration to directors is justified,<sup>53</sup> where the company has been allowed to engage in illegal activities, where funds have been raised by reckless means, including the sale of company assets at under value, to delay eventual insolvency, where the company has been bound to a significant transaction for the benefit of a third party without any concomitant benefit, where an unfair preference occurred after the declaration of insolvency, where judicial administration proceedings were not launched within 15 days of it becoming insolvent,<sup>54</sup> and where directors have failed to pay company debts for which the court has found them to be personally liable.<sup>55</sup>

In any of the instances where a court may impose personal bankruptcy, as an alternative to such an order, a court may simply prohibit an director from managing or directing, whether directly or indirectly, any business engaged in economic activity. The prohibition may be limited to the management of one or several companies, as opposed to within personal bankruptcy, which involves a general prohibition.<sup>56</sup> The prohibition also extends to any debtor or company director, acting in bad faith, who has failed to supply the administrator with a list of the creditors and the amounts of the debts within eight days of the opening of insolvency proceedings.<sup>57</sup>

Anyone who has been subject to an order declaring him personally bankrupt or prohibited from being involved in the management of a company must refrain from voting in general meetings of the debtor company. In these instances, the court will appoint a representative to exercise any voting rights attached to the company director's shareholding.<sup>58</sup> Any person subject to an order imposing personal bankruptcy or prohibited from managing or directing a company or anyone subject to an order placing him in liquidation proceedings is prohibited from holding any public office.<sup>59</sup>

The court imposing sanctions, including personal bankruptcy or a prohibition from being involved in the management of any company, is obliged to set a term for the duration of these sanctions, which may not be less than five years. Similarly, the prohibition against holding public office may not be less than the five-year period required by law. If, however, the person subject to these sanctions has paid a sufficient contribution towards extinguishing the

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<sup>52</sup>L. Art. 191.

<sup>53</sup>L. Art. 188.

<sup>54</sup>L. Art. 189.

<sup>55</sup>L. Art. 190.

<sup>56</sup>L. Art. 192 al. 1.

<sup>57</sup>L. Art. 192 al. 2.

<sup>58</sup>L. Art. 193.

<sup>59</sup>L. Art. 194.

company's debts, he may petition the court to lift all or part of the sanctions imposed by it.<sup>60</sup>

### **Criminal Liability**

The sanctions provided for in Title VII apply to all commercial persons, all persons who directly or indirectly, as an appointed director or acting as a shadow director, managed or liquidated a private-law body which carried out business activities as well as to representatives of other entities which acted as directors of the subsidiary body.<sup>61</sup> In cases involving the commission of a criminal act, the competent court will be the relevant court of first instance in the criminal hierarchy, provided the relevant limitation period has not elapsed.<sup>62</sup>

Proceedings may be initiated by the public prosecutor or through the opening of 'partie civile' proceedings by the administrator, liquidator, creditors' representative, employees' representative or rescue plan supervisor.<sup>63</sup> The courts have also decided that any creditors who have suffered a particular loss other than the amount of the debt owed them may open these proceedings before a criminal court.<sup>64</sup> The public prosecutor enjoys a right of access to any document held by the administrator or liquidator.<sup>65</sup> The costs of any 'partie civile' proceedings initiated by insolvency personnel are borne by the State and may only be recovered following the end of any liquidation proceedings.<sup>66</sup> Any convictions or other orders are published at the expense of the guilty parties.<sup>67</sup>

### **Criminal Bankruptcy**

In the event of judicial administration or liquidation proceedings being instituted, any person to whom the above is applicable may be found guilty of criminal bankruptcy where that person engages in raising funds by reckless means, such as the sale of assets at under value, in order to delay the onset of insolvency, misappropriates or conceals assets belonging to the company, fraudulently increases the debt owed by the company or falsifies, destroys or fails to keep those accounts required by law.<sup>68</sup>

The definition of what constitutes reckless means has been the subject of judicial interpretation. In one instance, a banker was found guilty of abetting the act of criminal bankruptcy by providing excess credit.<sup>69</sup> Normally, the provision of excess credit or means of finance which only serve to further in debt the business will found an action brought by a liquidator in the interests of other

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<sup>60</sup>L. Art. 195.

<sup>61</sup>L. Art. 196.

<sup>62</sup>L. Art. 210.

<sup>63</sup>L. Art. 211. 'Partie civile' proceedings are the means for third parties to obtain representation, usually with view to putting forward a claim for damages, in criminal causes.

<sup>64</sup>Cassation criminelle, 11 October 1993, D.1994.IR.18.

<sup>65</sup>L. Art. 212.

<sup>66</sup>L. Art. 213.

<sup>67</sup>L. Art. 214.

<sup>68</sup>L. Art. 197.

<sup>69</sup>Cassation criminelle, 3 April 1991, JCP 92 éd E I.154.11.

creditors with view to a finding of contribution by the bank.<sup>70</sup> Following the adoption of the Law of 1985, preferential payments to creditors no longer constitute an offence punishable by criminal law, although civil sanctions and a finding of liability for a contribution may apply.<sup>71</sup>

Accomplices to the fact may also face criminal sanctions whether or not they have the quality of commercial persons themselves, or does it matter whether they hold a management or shadow position, directly or indirectly, in the debtor company. They need simply have contributed to the existence of the debt. In addition to facing possible bankruptcy or prohibition against being involved in the management of a company, company directors guilty of criminal acts may face imprisonment for a term of 5 years together with a fine of FF 500,000.<sup>72</sup> Where the company concerned is quoted on the stock exchange, the penalties are increased to 7 years and FF 700,000 respectively.<sup>73</sup>

Where the author or accomplice to an act is an individual, the courts may additionally impose the following penalties, including the loss of civil rights, disqualification from being involved in the management of a company up to a maximum of five years or from exercising a profession where the offence was committed through a breach of professional rules, exclusion from a stock-exchange, also for a period of up to five years and loss of banking privileges, including the right to issue cheques. All these penalties may in addition be publicised.<sup>74</sup> The criminal court before which proceedings are held may decide that the individuals mentioned in Article 196 be pronounced personally bankrupt or that a disqualification from being involved in the management of a company apply to them.<sup>75</sup> Private-law bodies may face a finding of criminal liability and the imposition of fines and other penalties.<sup>76</sup>

### **Miscellaneous Offences**

Company directors may also be subject to imprisonment and a fine for criminal acts other than mismanagement. A company director, who may be subject to a term of 2 years imprisonment and/or a fine of FF 200,000 if during the period of observation he grants a mortgage over company property or otherwise disposes of company funds without proper authorisation or pays part or all of a debt which arose after the institution of insolvency proceedings.<sup>77</sup> Accomplices to the dissipation or dissimulation of assets acting in concert with those individuals mentioned in Article 196, persons who fraudulently declare non-existent debts and persons who have carried out business activities in the name of another person or using a false identity so as to conceal assets are all liable if found guilty to the same penalties provided for in the case of criminal

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<sup>70</sup>Cassation commerciale, 11 October 1994 no. 1802P, BRDA 94-20 at 7.

<sup>71</sup>Cassation criminelle, 21 June 1993, Les Petites Affiches 26 January 1994 No. 11, p. 20.

<sup>72</sup>L. Art. 198.

<sup>73</sup>L. Art. 199.

<sup>74</sup>L. Art. 200.

<sup>75</sup>L. Art. 201.

<sup>76</sup>L. Art. 202.

<sup>77</sup>L. Art. 203.

bankruptcy.<sup>78</sup> This rule also applies to the spouse and relatives of any of those individuals.<sup>79</sup>

### **Summary**

The Law of 1985 presents a formidable array of weapons to be used against the incompetent director. Indeed, the availability of a range of measures seems tailor-made to ensure that relative degrees of culpability are accordingly punished, ensuring protection of the public from the consequences of management mistakes. Judges are more forward in seizing the initiative to initiate proceedings and have a battery of compliance-ensuring measures. Nevertheless, the ability of a judge in France to apportion blame for management mistakes is still very much dependent on experience, both of the individual judge and of the court, in relatively complex commercial matters. The existence of these measures still require directors and officers to be vigilant in the exercise of their duties. This particularly affects the non-resident foreign director, who is as liable as his peers and who should endeavour to be kept informed of all financial decisions with an implication on business strategy.

**16th January 1996**

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<sup>78</sup>L. Art. 204.

<sup>79</sup>L. Art. 205.