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Risks for Transactions and Directors in Financially Distressed Businesses in Luxembourg

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A Practice Note addressing the legal and practical considerations in Luxembourg for a company director where that company is in financial distress and may subsequently enter insolvency proceedings. This Note also outlines the types of claim that an official appointed to oversee the insolvency proceedings or represent the creditors' interests, or both, may bring against the company's former directors, or to unwind transactions that took place before any insolvency proceedings.

When a Luxembourg company is in financial distress and begins insolvency proceedings there are a variety of legal and practical issues to consider. Before insolvency proceedings begin, directors are obligated to fulfil their duties to the company, its creditors, and shareholders, and will need to consider the status of any ongoing transactions being undertaken by the company. Once insolvency proceedings begin, the pre-insolvency actions of the directors can be scrutinised for potential claims by insolvency officials attempting to achieve the greatest return for the company's creditors and transactions may be challenged or unwound.

This Note examines the legal and practical issues involved in the insolvency laws of Luxembourg and addresses:

- The duties that directors owe to their company, its shareholders, and its creditors, and how these may change according to the company's financial situation.
- The investigation of the pre-insolvency actions of the directors by insolvency officials.
- The powers of the insolvency officials to unwind ongoing transactions and implement general powers of recovery to achieve the greatest possible return for the company's creditors.
- The potential for claims against the company's directors, and whether the directors can be held liable personally for their conduct, even if ordinarily they would not be liable for the insolvent company's debts.

The Luxembourg Parliament is currently working on a draft to modernise Luxembourg's insolvency law (Bill of law No. 6539A on business preservation and the modernisation of bankruptcy law), which is anticipated to be adopted in 2023 (see Potential Changes in Insolvency Law).

Luxembourg Directors' Pre-Insolvency Duties

Luxembourg statutes and general civil law govern the duties of directors in relation to both:

- Public limited liability companies (*sociétés anonymes*).
- Private limited liability companies (*sociétés à responsabilité limitée*).

The laws governing the duties of company directors include:

- Law of 10 August 1915 on commercial companies, as amended (Commercial Companies Law).
- Law of 19 December 2002 on the register of commerce and companies and the accounting and annual accounts of undertakings, as amended (Law of 19 December 2002).
- Commercial Code.

Under Luxembourg laws, a director's main duties include:

- Duty of care, requiring directors to act in the best interests of the company, with the same loyalty, care, and diligence an ordinary prudent person would have in the same position.
- Duty to act in the company's best interests, requiring directors to act in good faith in what they consider to be the best interest of the company itself, as distinct from the interests of the shareholders. Before approving any transaction, directors must balance the potential corporate benefit against the potential risk or liability exposure.
- Duty to act in accordance with the company's articles of association (articles) and applicable Luxembourg

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law. When reviewing a transaction, directors should consider:

- whether any legal or internal restrictions apply; and
- whether the directors are authorised to approve such a transaction.

- Duty to disclose any conflicts of interest or abstain from acting. If a director has a direct or indirect financial interest that conflicts with the company's interest in a transaction, the director must:
  - advise the board of the conflict; and
  - request the disclosure of the conflict to be recorded in the minutes of the meeting.
- Duty of confidentiality, prohibiting directors from using or sharing information that the company has obtained:
  - with third parties (including other entities within the same company); or
  - for their personal use.

Luxembourg law also imposes certain statutory duties on directors. These include, among others, the requirement to:

- Report on the company's annual financial accounts and submit these to the company's shareholders (Articles 310-5 (3) and Article 710-23, Commercial Companies Law).
- File the company's annual financial accounts with the Luxembourg Trade and Companies Register (Article 75 and following, Law of 19 December 2002).
- Convene shareholder meetings when necessary. If a Luxembourg public limited liability company or Luxembourg partnership limited by shares (*société en commandite par actions*) experiences a financial loss and its net assets fall below 50% of its corporate capital, even if the company is not insolvent or at risk of becoming insolvent, the board has a duty to convene a general meeting within two months of discovering the loss. The purpose of this meeting is to decide whether to dissolve the company (Article 480-2, Commercial Companies Law).

Liability of Directors

Civil Liability

Directors may be subject to civil liability in the following circumstances:

- **Mismanagement (Articles 441-9(1), 441-9(3) and 710-16, Commercial Companies Law).** Company directors are expected to conduct themselves with the loyalty, care, and diligence of an ordinarily prudent person in their position (*bon père de famille*). The special responsibility of a director falls under the rules of its respective mandate. Non-compliance with the obligations a director has under its mandate may lead to liability claims. A director can only be held responsible where there has been fault on their part, which may include by, among other things:
  - entering into agreements without conducting a proper analysis;
  - failing to properly monitor individuals undertaking daily management of the company; or
  - failing to attend board meetings.

  Only the company itself can invoke a claim for mismanagement and if liability is found, directors are jointly and severally liable for mismanagement in accordance with the responsibilities granted to them by the company. The assessment of fault varies (and is more vigorous) depending on whether or not the director's mandate was remunerated.

  To establish liability for mismanagement, the company must show that:
  - a prudent and diligent person in the same circumstances as the director would not have mismanaged the situation;
  - the director's mismanagement caused the company or a third party to suffer damage; and
  - there is a causal link between the director's fault and the damage caused.
- **Breaching the Commercial Companies Law or the company's articles (Articles 441-9(2) and 441-9(3) and 710-16, Commercial Companies Law).** This can lead to a director's joint and several liability towards the company and third parties. In relation to third parties, directors do not enter into any personal obligation with regard to the company's commitments, but they are jointly and severally liable for violation of the Commercial Companies Law and/or the company's articles.
- **Committing wrongful acts under the general liability regime (Articles 1382 and 1383, *Civil Code*).** Any individual shareholder can bring a claim against any director if their rights were affected by any actions related to the company by a director or third party.

Criminal Liability

Directors are subject to criminal liability in the following circumstances:

- If a director:
  - failed to present financial information to the company's shareholders or provided shareholders with false or incorrect financial information;
  - failed to file and publish the company's annual financial accounts; or

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  - paid distributions to shareholders for amounts other than what is available for distribution.
- If the director misused corporate assets or powers.
- If the director committed an offence under general law, such as embezzlement.
- If the director committed an offence relating to the insolvency of the company (see Criminal Bankruptcy).

(Article 1500-1 and following, Commercial Companies Law; Article 573 and following, Commercial Code.)

Potential sanctions for criminal liability can include:

- Fines.
- Imprisonment.

Tax Liability

Directors of commercial companies must ensure all tax obligations are fulfilled for all company employees. These obligations include ensuring that:

- All required taxes are paid, including penalties and other interests.
- All required statutory tax deductions are taken from employees' salaries and passed on to the tax administration.
- Payment is made of applicable:
  - group income tax;
  - municipal taxes;
  - wealth taxes; and
  - withholding taxes.

Luxembourg imposes a special system of personal and joint and several liability for company directors regarding administration of the company's tax liabilities (§§ 103 and 109, General Tax Law (*Abgabenordnung*)). If a director fails to comply with these tax obligations they will incur personal financial liability.

Luxembourg Bankruptcy Proceedings

The standard insolvency procedures for commercial companies are bankruptcy proceedings (*faillite*). Bankruptcy proceedings can be opened by any of the following entities making an application to the court:

- The insolvent company itself, via its directors.
- Any creditor.
- The Luxembourg Commercial Court, acting on its own initiative (*ex officio*).

Cessation of Payments

Under Luxembourg law, a company is in a state of "cessation of payments" when it is unable to repay debts which are due and payable. Directors must file a petition for bankruptcy for the company within one month of becoming aware of the cessation of payments. The bankruptcy petition is made to the registry of the district court where the company's registered office is located (Article 440, Commercial Code).

If directors do not file for bankruptcy when they become aware that the company is in cessation of payments:

- The directors may become personally liable to the company or any third party for failing to carry out the duties they owe to the company.
- The directors may be criminally liable for simple bankruptcy (Article 573, Commercial Code, and see Criminal Liability).

Change in Directors' Duties

Directors must always act in good faith and in the company's best interests. Therefore, there is no change from the duties owed to the company from the pre-insolvency period to formal bankruptcy proceedings. Directors can be civilly and criminally liable for improper action both before and after the onset of insolvency and can even be financially liable to the company during these times (see Liability of Directors).

Duties of the Bankruptcy Receiver

Once bankruptcy proceedings are initiated by the court, a bankruptcy receiver (*curateur*) is appointed to:

- Represent the debtor company through the insolvency process and manage the company's day-to-day affairs (see Manage the Debtor During Bankruptcy).
- Liquidate the company's assets for the benefit of its creditors and act as a representative of the collective interests of the company's creditor body (collectively referred to as the "mass of creditors" (*masse des créanciers*)) (see Manage the Debtor During Bankruptcy).
- Investigate the company's pre-insolvency transactions (see Investigation of Pre-Insolvency Actions).

Manage the Debtor During Bankruptcy

The receiver is responsible for conducting all legal actions on the company's behalf, including:

- Approving or rejecting claims to the company's assets.
- Establishing the company's full list of creditors.

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- Initiating actions for damages if the company's actions or the actions of third parties have caused a loss to the mass of creditors.

(Les Novelles, page 630, point 2162: Gand, 20 July 1897, Pas., 1898, II, 66; Cass. 14 Dec, 1899, Pas., 1900, I, 59; Civ. Gand, 5 oct. 1932, Jur. Des Fl. 1932, n° 5268.)

If the receiver brings an action against a third party, the receiver will need to prove the third party's liability in tort or a quasi-tort by showing:

- The third party's fault.
- That the fault caused damage to the mass of creditors.
- The causal link between the fault and the damage caused.

(Articles 1382 and 1383, Civil Code.)

Once bankruptcy proceedings are formally opened, any ongoing agreements existing between the bankrupt company and third parties continue to be in force and are not automatically terminated. However, the receiver can choose which in-force agreements they wish to keep and terminate those they consider to not be in the company's best interests. If the receiver terminates any agreements, the counterparty is entitled to file a claim for damages.

Liquidate the Debtor's Assets for the Benefit of Creditors

A bankruptcy receiver's duty is to liquidate the insolvent company's assets for the benefit of the creditors. This is generally carried out through the sale of the company's assets by the receiver (the sale of real estate would, for example, be conducted by public auction). The receiver then distributes the sale proceeds from the liquidated assets to the creditors in accordance with their established legal ranking, with secured and preferential creditors ranking above unsecured creditors.

If the proceeds from liquidating the company's assets are insufficient to satisfy the claims of all the unsecured creditors, the proceeds will be divided pro rata in accordance with their respective claims (*au marc le franc*). Disputes among the creditors concerning their ranking on liquidation are settled by the court. Prior to making any distributions, however, the receiver must conduct investigations to:

- Establish the company's relevant assets.
- Review directors' pre-insolvency transactions for a potential challenge.

Investigation of Pre-Insolvency Actions

Once appointed, the bankruptcy receiver investigates the director's pre-insolvency actions and submits a report to the Luxembourg Public Prosecutor's Office (PPO) (Article 494, Commercial Code). The purpose of the receiver's report is to:

- Identify whether any wrongdoing occurred by the company and its directors.
- Provide an indication to the PPO as to whether the PPO should take any action regarding the company's directors.

The report is submitted to the PPO no later than six months from the date of opening the bankruptcy proceedings.

If the receiver finds that any of the company's directors (including any de facto directors) personally contributed to the company's financial losses due to their gross and qualified negligence (*faute grave et caractérisée*), those directors can be disqualified from acting as a director for a period of one to 20 years (Article 444-1(3), Commercial Code). This means the director would be prevented from:

- Conducting any direct or indirect commercial activities.
- Acting in any capacity where they have the power to bind a company, including as:
  - manager (*gérant*);
  - director;
  - statutory auditor;
  - accountant.

To disqualify a director, a request must be submitted by the receiver or the PPO to the competent district court within three years from the commencement of bankruptcy proceedings (Article 444-1(2), Commercial Code). In addition to reporting to the PPO on any criminal wrongdoing and making recommendations for disqualification, the receiver is authorised under the Commercial Code to:

- Issue claims against former directors.
- Bring requests for the court to set aside certain pre-insolvency transactions.

Claims Against Former Directors

Personal Bankruptcy Claim Against Director

If the receiver discovers wrongdoing on the part of a director, it is possible for bankruptcy proceedings to be opened against that director personally. For these purposes, a director includes any legally appointed director or any person or entity that fulfils the role of director (whether formally or informally appointed, paid or unpaid and/or whether their functions were disclosed or undisclosed).

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Personal liability can arise if the director:

- Conducted company business for their own personal benefit, masking their actions as for the benefit of the company.
- Used company assets as if they were their own.
- Pursued a loss-making activity that would inevitably lead to the cessation of payments:
  - in their own personal interest; and
  - in an abusive manner.

(Article 495, Commercial Code.)

Claim for Personal Contributions from Directors

The receiver, acting on behalf of the creditors, can request the court to hold that some or all the company's debts be borne (jointly or severally) by a company director if:

- A director has committed an act of gross and qualified negligence which contributed to the bankruptcy of the company.
- The company's assets appear to be insufficient to meet its liabilities during a bankruptcy proceeding,

(Article 495-1, Commercial Code.)

Criminal Bankruptcy

Directors can be subject to criminal liability when their misconduct involves:

- Simple criminal bankruptcy.
- Fraudulent criminal bankruptcy.

Simple and fraudulent criminal bankruptcy are not mutually exclusive and directors can be found liable for both types of offence.

Simple Criminal Bankruptcy

Directors commit simple bankruptcy under Articles 573-576 of the Commercial Code if they (among other things):

- Fail to file for bankruptcy proceedings within one month of becoming aware that the company is in cessation of payments (unable to pay its debts).
- Borrow money to provide the company with funds when they are already aware that the company is insolvent.
- Upon request for information by the supervisory judge (*juge-commissaire*) or bankruptcy receiver either:
  - fails to provide them with relevant information; or
  - deliberately provides them with false or inaccurate information.

A director found guilty of simple criminal bankruptcy may be subject to imprisonment of up to two years.

Fraudulent Criminal Bankruptcy

A director commits fraudulent criminal bankruptcy under Articles 577 to 578 of the Commercial Code if they (among other things):

- Conceal company books or fraudulently erase or alter their contents.
- Misappropriate or conceal any part of the company's assets.
- Consider the company to be the debtor for debts that the company does not actually owe.

A director found guilty of fraudulent criminal bankruptcy and may be subject to imprisonment of five to ten years.

Under Bill for Law No. 6539A on business preservation and the modernisation of bankruptcy law, the Luxembourg government has indicated an intent to sunset fraudulent bankruptcy as a criminal offence. When the new law is adopted, fraudulent bankruptcy is expected to be dealt with as an offence (*délit*) rather than a crime. This is to ensure that the measures for enforcement can be engaged more rapidly and efficiently (see Potential Changes in Insolvency Law).

Challenging and Unwinding Transactions in Bankruptcy

Luxembourg insolvency law makes use of a "suspect period" before the onset of formal bankruptcy proceedings. During the suspect period, if directors enter into certain transactions on the company's behalf, they can be declared null and void by the court. The suspect period is calculated beginning from six months prior to the date of the opening of formal bankruptcy proceedings (as determined by the judge). This date is generally the date of cessation of payments, when the company becomes unable to pay its debts (Article 442, Commercial Code).

If the bankruptcy receiver discovers that the company entered into suspicious transactions during the suspect period (and in some instances, during the ten days prior to the start of the period), the receiver can apply to the court for these transactions to be declared null and void (see Void Transactions). In addition, certain transactions can be declared to be voidable at any time, even outside of the suspect period, if the transaction was entered into for the purpose of defrauding the company's creditors (see Voidable Transactions).

Void Transactions

The receiver, acting on behalf of the creditors, can request the court to set aside any of the following

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transactions as void, if the transaction was entered into during, or in the ten days prior to the commencement, of the suspect period:

- An agreement to transfer movable or immovable property for zero consideration, or any onerous agreement for insufficient consideration.
- A payment, assignment, sale, or set-off made by the debtor for a debt that has not yet become due, or any payment made using anything other than cash or bills of exchange for a debt that has become due.
- A contractual or legal mortgage, pledge, or charge for the debtor's assets to repay a prior debt.

(Article 445, Commercial Code.)

The judge is obligated to declare the transaction void if it falls within one of the categories set out in Article 445. Under Luxembourg law, the receiver is not required to prove bad faith or fraudulent intent on the part of the third party to the transaction for the transaction to be void.

Rights of mortgage and privilege that have been validly acquired can be registered until the date of the opening judgment. However, registrations made during the ten days prior to the date of cessation of payments or subsequently may be declared void, if more than 15 days have elapsed between the date of the mortgage deed or privilege and the registration date of the mortgage or privilege. (Article 447, Commercial Code).

Voidable Transactions

The receiver can apply to the court for a transaction to be set aside as voidable if the company's directors enter into a transaction with a third party concerning due debts or an unduly onerous act on the part of the company, if the following conditions are met:

- The transaction was entered into after the court determine date of cessation of payments rendering the company insolvent.
- The transaction was entered before the court's decision to formally open bankruptcy proceedings.
- The third party knew conclusively that the company was insolvent at the time of entering into the transaction.

(Article 466, Commercial Code.)

Belgian case law, which is traditionally followed by the Luxembourg courts, sets an additional requirement in relation to voidable transactions that the insolvency estate have a vested interest in seeing the transaction annulled (Traité de droit commercial belge, Louis Fredericq, tome vii, (première partie), 1949, page 251 and following). To be set aside as voidable, the transaction must have:

- Caused actual loss to estate.
- Breached the principle of equality of creditors.

Fraudulent Transactions

The receiver can request the court set aside any transaction that was intended to defraud the company's creditors (Article 448, Commercial Code). Unlike void and voidable transactions, fraudulent transactions can be set aside even if they had occurred outside of the suspect period.

To establish a fraudulent transaction claim, the receiver must demonstrate that:

- The creditors have suffered a loss.
- The debtor company acted with fraudulent intent.

To demonstrate fraudulent intent, it is sufficient for the receiver to establish that the company:

- Committed an abnormal act.
- Acted with the knowledge that this would prejudice the creditors.

It is not necessary for the receiver to establish that the company acted with actual intent to do harm to prove a fraudulent transaction.

The European Parliament and the European Council have issued proposals to harmonise certain aspects of insolvency law in COM (2022) 702 to set common rules for avoidance actions (see Under Bill for Law No. 6539A on business preservation and the modernisation of bankruptcy law, the Luxembourg government has indicated an intent to sunset fraudulent bankruptcy as a criminal offence. When the new law is adopted, fraudulent bankruptcy is expected to be dealt with as an offence (délit) rather than a crime. This is to ensure that the measures for enforcement can be engaged more rapidly and efficiently (see Challenging and Unwinding Transactions in Bankruptcy).

Financial Collateral Arrangements

Article 20(1) of the Luxembourg law dated 5 August 2005 on financial collateral arrangements, as amended (Financial Collateral Law) financial collateral contracts (*contrats de garantie financière*), which can include (among other things) pledges and transfers of ownership for security purposes, the granting of collateral over financial instruments or claims, as well as set-off arrangements agreed by the parties, are valid and binding on third parties, auditors, administrators, liquidators and other similar bodies (notwithstanding the existence of reorganisation measures), winding-up proceedings, or any other situation involving any creditors' process (*situation de concours*), whether national or foreign.

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Article 20(4) of the Financial Collateral Law further provides that (among other things) the provisions of the Commercial Code concerning insolvency, bankruptcy and moratoria as well as the national or foreign provisions applicable to reorganisation measures, liquidation proceedings or any other situation involving any creditors' process do not apply to financial collateral arrangements and will not prevent their enforcement. This also applies to the "hardening-period rules", except for voidance in the case of fraud of other creditors (*actio pauliana*).

Finally, Article 24 of the Financial Collateral Law provides that the national provisions on insolvency, bankruptcy, suspension of payments, reorganisation measures, liquidation proceedings or any other situation involving any creditors' process referred to in Article 20(4) of the Financial Collateral Law will not apply where the grantor of the financial collateral (*garantie financière*) or other similar collateral (*toute autre garantie similaire*) to which foreign law applies is incorporated or established in Luxembourg.

Potential Changes in Insolvency Law

Luxembourg Parliament is currently working on a draft to modernise Luxembourg's insolvency laws (Bill of law No. 6539A on business preservation and the modernisation of bankruptcy law), which is anticipated to be adopted in 2023. Among others, this new law is expected to introduce new reorganisation measures which will repeal the current procedures for:

- Controlled management.
- Suspension of payments.
- Pre-bankruptcy composition arrangements with creditors.

A primary goal of the new law is to help companies avoid formal bankruptcy proceedings when they encounter financial difficulties through the creation of warning signals to aid companies in quickly identifying financial difficulties and taking preventative measures.

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