Directors' duties and liability in the vicinity of insolvency

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The Fiduciary Duties of Directors

When a company enters the zone of insolvency (the so-called "twilight zone"), conflicts of interest between the company, its shareholders and the different stakeholders, such as creditors, are ignited and the pressure on directors for contradictory forms of action is intensified.

The Portuguese Commercial Companies' Code (abbrev., CSC) and the Portuguese Corporate Recovery & Insolvency Code (abbrev., CIRE) contain rules on director's fiduciary duties.

Amongst other rules, the CSC lays down the directors' duty of loyalty to act in the interest of the company, considering the long-term interests of the shareholders and taking into account the interests of other relevant stakeholders for the sustainability of the company, such as its employees, clients and creditors.

On the other hand, the CIRE provides that directors have a duty to immediately file for insolvency in case of cash-flow insolvency or balance-sheet insolvency, within 30 days from the date they become aware (or should have been aware) of the state of insolvency.

Moreover, the CIRE states that imminent insolvency (*insolvencia eminente*) is tantamount to actual insolvency should the company file for insolvency.

When is a company in imminent insolvency (Twilight Zone)?

Conceptually, the CIRE defines that there is a state of insolvency when the company is unable to satisfy its creditors' claims as they fall due ("cash-flow insolvency") or when its liabilities are manifestly higher that the company's assets evaluated according to the applicable accounting rules ("balance-sheet insolvency").

The CIRE does not however provide for any conceptual definition or guidance as to what may be considered imminent insolvency, nor have Portuguese courts clarified anything in this regard.

Some legal authors[1] argue that *imminent insolvency* exists in circumstances where the company meets its creditor claims and has asset values in excess of liabilities but in the foreseeable future will not be able to pay its debts as they fall due, considering the specific circumstances of the company and its objective expectations, notably in face of its aggregate assets and liabilities. In the absence of a formula or test, directors continue to rely on cash-flow or balance-sheet tests in order to evaluate if the company is in the vicinity of insolvency.

Notwithstanding the above and though each case must be examined independently, based on the most

[1] Luis A. Carvalho Fernandes / João Labareda

recent court decisions the following may be regarded as warning signs of insolvency:

— Late or non-payment of undisputed claims

— Loss of the company's capital – i.e. equity is below 50% of the company's nominal capital and no remedial action is taken

— Failure to keep in order and file statutory annual accounts

— Default or foreseeable default on loan covenants

— Failure to obtain new financing or to renegotiate existing financing.

— The auditors' report on the accounts expresses the opinion that the company will not continue as a going concern

— Purchase of merchandise with recourse to a credit facility and selling it for a lower price prior to settling the credit facility

What are the directors' liabilities?

Under the CIRE, the liability for insolvency may be extended to the individuals responsible for the company's management (including *de facto* directors); notably, within the characterisation of insolvency as intentional, raised as an incidental issue. With regards to such liability, the CIRE establishes a presumption of intentional behaviour if the directors failed to file for insolvency in a timely manner.

At the same time as the intentional-insolvency incident, the court has an obligation to notify the criminal authorities for the purpose of investigating potential criminal liability of the directors; notably, to verify if in any way directors defrauded creditors and/or fraudulently contributed to the insolvency of the company.

In addition to the above and separate from the intentional insolvency incident, the directors' liability to creditors under the CSC – i.e., establishing that directors shall be liable to creditors if the company's assets become insufficient to satisfy the creditors claims because of an intentional breach of creditor-protection rules or contractual provisions - may also be enforced within the insolvency proceedings by the trustee in insolvency (*administrador de insolvência*).

What options do directors have to protect themselves?

In a solvent situation, directors should give priority to having in place a corporate governance model that is tailored to the company, such as control and supervision mechanisms and management compliance programmes, ensuring that such model / programmes actually work and are implemented in practice and that they are reviewed and adjusted according to the company's evolving circumstances.

In order to protect themselves when a company is entering the twilight zone, directors should consider, amongst other actions that may apply to the particular circumstances of the case, the following:

— Have the company's accounting records up to date and in good order;

— Base their decisions on an informed judgement, notably by hiring adequate advisors;

— Act free of interest and in good faith;

— Refuse to act if their independence is at risk;

— Intensify director action and availability, namely at the board-of-directors level;

— Record their actions and opinions;

— Refrain from engaging in high risk activities;

— Trigger the "re-capitalize or liquidate" rules if the company is in a loss of capital situation, by reporting and calling for a general meeting of shareholders. In this regard, it is worth saying that Portuguese law has implemented the EU Second Directive as a mere duty to call a meeting, whereby shareholders are not under the obligation either to recapitalize or to dissolve the company. Practice shows that the recapitalize/liquidate mechanism has had low impact in Portuguese companies in pre-insolvency situations;

— File for a special revitalization process (*processo especial de revitalização*). The PER, pre-insolvency in-court proceedings, attempts to reach a restructuring (adjustment of debt) agreement to the extent that there is a pragmatic scenario for revitalization. It is conceived as a mechanism to favour financially-distressed debtors that face economic difficulties (i.e., unable to meet their obligations, or having difficulties to do so, namely due to lack of liquidity or difficulties to acquire additional capital) or imminent insolvency (not applying, therefore, to companies declared insolvent by a court of law with the opening of insolvency proceedings);

— Resort to SIREVE, an out-of-court pre-insolvency procedure that may be used by any company facing a *difficult economic or financial situation, or imminent insolvency*;

— Ultimately, file for insolvency if the directors believe, on the basis of the specific circumstances of the company, that the situation of imminent insolvency is irreversible.