2015/Issue 4 (Volume2): Economy and Finance



# THE CORRELATION BETWEEN A COMPANY'S THREATENING INSOLVENCY AND ITS DIRECTOR'S LIABILITY (Part 1)

*Sándor Fónagy*

The threat of insolvency arising at a company brings a decisive change from the point of view of the liability of the company's director, since from this point on the latter is bound to proceed *with consideration for the interests of creditors*. The director may carry on managing the company unchanged; however, for as long as there is still threatening insolvency, or unless the liquidation of the company is ordered, *he or she must refrain from taking any unwarranted risks*. Should this obligation be broken, the competent court – responding to the lawsuit of a creditor with an outstanding claim under the company's liquidation process – may obligate the director to pay compensation. In this study, after reviewing the specific details of the director's liability towards creditors and the procedure for enforcing a claim, my primary intention is to examine when and by what testing method it is possible to determine whether the threat of insolvency has arisen.

*JEL codes: K220, K130, G320, G330*

*Keywords: insolvency, threatening insolvency, liquidation, director's liability, wrongful trading*

## 1. THE DIRECTOR'S LIABILITY TOWARDS THE COMPANY

We must differentiate between the *internal* liability of the director towards the company, and their *external* liability for damages caused to third parties (in the course of representing the company, or at least in connection with its activities).

According to Section 3:112, paragraph (2) of the "new" Civil Code that came into effect on 15 March 2014, regulating the internal liability of company directors: "The director shall manage the operations of the company independently, *based on the primacy of the company's interests*. In this capacity, the director shall discharge his duties in due compliance with the relevant legislation, the articles of association and the resolutions of the company's supreme body." (This is what is known as the principle of "duty of care" or "duty of loyalty" to the company.) This provision is not without precedent, as Section 30, paragraph (2) of Act IV of 2006 on Business Associations (hereinafter the "Companies Act"), which was repealed when the Civil Code entered into effect, had this to say about the liability

of company directors: "Directors shall conduct the management of the company with due care and diligence as generally expected from persons in such positions and – unless otherwise provided in this Act – give priority to the interests of the company. Directors shall be liable to the company in accordance with the general rules of civil law for damages caused by any infringement of the law or any breach of the articles of association, the resolutions of the company's supreme body, or their management obligations."

The Civil Code placed liability for damages caused by breach of contract on new foundations. According to Section 3:24 of the Civil Code, the director will be held liable for damages caused to a legal person in the course of his management activities, in accordance with the provisions on liability for damages caused to a legal person by breach of contract (Section 6:142). Under Section 6:541, if the director of a legal person causes damage to a third party in connection with their office, liability in relation to the injured person lies with the director and the legal person jointly and severally. The task of interpreting these points of the law, as well as determining the limits of the director's liability, has given rise to disputes among legal authors. It is not my intention in the present study to deal with these points of law establishing liability, as essentially they do not relate to the point of a company's lifespan where it is left without a legal successor (e.g. at its termination through liquidation). At the same time, it is conceivable that a claim against the director for compensation for damages affecting the company as the injured party, and incurred during the company's normal operation, will be preferred by the liquidator on behalf of the company under liquidation, and that at this point the preferring of such a claim serves the interests of creditors (a question I will deal with further in point 3.5). Before analysing liability for losses towards creditors, I think it justified to briefly examine the standard measure of directors' liability.

Although not stated in the provisions of the Civil Code, in my view the requirement of the Companies Act that a director should be obligated to proceed with the due (heightened) level of care expected of a person in such a position remains authoritative. The law therefore established a benchmark procedure for directors not with respect to the conduct generally expected in a given situation, but for the heightened degree of care expected of a person in such a position.[1] This is to say that it is implicitly expected of the director of a jointly owned company that they should possess the fundamental knowledge (of economics, accounting and the law) required in the business sphere. Moreover, when proceeding on behalf of the company, the director should represent the company's interests unconditionally and consistently, these interests being of an implicitly financial nature that must be guaranteed priority above all other interests.

1 Ruling of the Curia no. BH 2001. 594.

The oft-cited ruling no. BH 2004. 372 of the Curia (Hungary's supreme court) states: "The bad business decision made by the director, though indisputably causing damage to the company, cannot be regarded as unlawful conduct *in the absence of any other element bearing on the case*." In the case in question, the joint-stock company appearing as the plaintiff, in its suit brought against its former managing director, sought to enforce payment of HUF 33,169,570 capital plus interest under the legal title of damages, arguing that the defendant had failed to proceed with the due care expected of a person holding the chief executive position. The defendant made advance payments in cash on concluding certain supplier contracts, or provided cash advances to suppliers in lieu of bank guarantees. Given that the contracts were not subsequently fulfilled, the plaintiff suffered losses due to the failure to secure repayment of the cash advances already transferred. The court dismissed the suit, accepting the managing director's defence that they had acted with the due care expected of their office when signing the contracts, had gathered information in advance on the parties signing contracts with the company, and had had the contracts drawn up by the company's lawyers. A condition for the liability of directors is that the damages are caused by deliberate or negligent action, but the court ruled that the defendant's conduct had not been unlawful. In the reasoning for its ruling, the court stated: "In proceeding on behalf of the company, the defendant undeniably made a bad deal; however, this 'passes' within the limits of business risk and cannot be qualified as unlawful conduct." Another factor with a bearing on the case is that the plaintiff had a workforce structure employing over 1,000 workers, in which the defendant's responsibility as managing director extended to the efficient operation of the entire organisation. It is worth noting that this ruling should not lead to the general conclusion that a managing director is never liable for damages if he or she delivers a large quantity of goods for which recompense is subsequently not received.

To support my standpoint, and at the same time by way of a contrast with the above-mentioned ruling, I refer to the judgement of the Budapest Court of Appeal (reached in the suit for damages which I myself brought on behalf of the plaintiff limited company then under liquidation), in which it was established that the managing director is liable for damages if they sell the company's entire stock of goods to a buyer which already owes a significant amount of outstanding debt, but without incorporating any kind of contractual guarantee nor taking any steps to collect the debt; whereafter the buyer company has been terminated as the result of liquidation proceedings, leaving the debt irrecoverable.[2]

In the suit for damages filed on the basis of Section 30, paragraph (2) of the Companies Act, the court determined that the director does not bear responsibility per se for losses occurring during the operation of the company, but only if measures

2 Budapest Court of Appeal 1.Gf.40.219/2007.

they have taken during their work cause culpable damage to the company.[3] In the practice of the courts, compelling the director to pay compensation necessitates a surplus burden of proof in the bearings of the case. Grounds for internal liability for losses existed if, based on the contract concluded by the director, the ordered goods were delivered not to the represented company but to another company in which the director had an interest.[4] The managing director also bore responsibility for damages if – contrary to a decision of the shareholders' meeting – he or she concluded a new contract despite the resolution of the shareholders' meeting to immediately reduce outgoings and expenditures in view of the company's deteriorated financial situation, as well as its stipulation that the managing director could only undertake new obligations, contracts and orders with the signature of another individual.[5]

Provided the company is operating profitably (is not insolvent), and the director – to take some examples – grants a loan without collateral, buys a valuable company car from company funds, sells tangible assets at below market value or repays a member's loan, and the members/shareholders in the company are aware of these transactions or decisions and approve them by resolution or tacit agreement, then the director is not liable for damages towards the company. If, however, the director concludes these transactions with the company under the threat of insolvency, then they may establish a basis for their own direct responsibility for losses towards creditors at their own expense (provided that the transactions fall in the period within three years preceding the start date of liquidation proceedings, as I shall touch upon in the following point).

## 2. THE DIRECTOR'S LIABILITY TOWARDS CREDITORS

The external liability of the director primarily means their responsibility towards the company's creditors. Section 3:118 of the Civil Code regulates *the liability of the director in respect of third parties:* "In the event of a company's dissolution without succession, creditors may bring action for damages up to their unsatisfied claims against the company's directors on the grounds of non-contractual liability, should the director affected *fail to take the creditors' interests into account* in the event of an imminent threat to the company's solvency. This provision is not applicable in the case where the company is dissolved without going into liquidation." This provision of the Civil Code corresponds to Section 30, paragraph (3) of the Companies Act (in force until 15 March 2014), which states: "In the event

3 BDT. 2008. 1767.
4 Curia Pf. VI. 21.128/1994/5.
5 BH 2001. 594.

of any imminent threat of the company's insolvency, the directors shall conduct the management of the company *giving priority to the company's creditors*. In the event that non-compliance with this obligation is verified and if the company is deemed to be insolvent, the directors affected may be subject to financial liability toward the company's creditors under other specific legislation." The separate legislation providing the content of the above-quoted Section 30, paragraph (3) of the Companies Act was Section 33/A of Act XLIX of 1991 on bankruptcy and liquidation proceedings (hereinafter the Bankruptcy Act), which I examine in the present study. The difference between the two passages of legislation is that while the Companies Act stipulates the principle of primacy with regard to creditors' interests, the Civil Code (and Section 33/A of the Bankruptcy Act, modified as the new Civil Code entered into effect and currently authoritative with regard to liquidation proceedings begun after 15 March 2014) stipulates only that the interests of creditors are taken into account. However, my view is that this discrepancy in wording does not affect the capacity to determine the director's liability.[6] I concur with Andrea Csőke's observation that: "Section 3:118 of the Civil Code can only be regarded as a general rule or basis, compared to which Section 33/A of the Bankruptcy Act – and, following an involuntary dissolution procedure, Section 118/B of [Act V of 2006 on public company information, company registration and winding-up proceedings] – contains specific provisions in the event of liquidation. There is no separate legal title, and hence no possibility for the creditor to file a suit citing this provision."[7] Section 3:118 of the Civil Code did not create a new legal title for establishing the director's liability, for which the content is still provided by Section 33/A of the Bankruptcy Act.

Section 33/A of the Bankruptcy Act, to be applied in liquidation proceedings begun after 1 July 2006, is the first specific framework in bankruptcy law under which the director can be held liable for the company's debts (that are not settled from liquidated assets). My view is that the legal practice that came about on the basis of Section 33/A of the Bankruptcy Act continued to apply unchanged after the new Civil Code entered into effect.

Section 118/B, paragraph (1) of Act V of 2006 on public company information, company registration and winding-up proceedings also enables the liability of the director towards creditors to be determined: "If the court of registry has deleted the company from the register in the course of an involuntary dissolution proce-

6 According to Section 91, paragraph (17), point f) of Act CCLII of 2013 governing the amendment of individual laws connected to the entry into force of the new Civil Code, the words "on the basis of primacy" are replaced by "taking into account" in Section 33/A, paragraph (1) of the Bankruptcy Act.

7 Andrea Csőke (2015): The liability of the executive officer in the event of insolvency and liquidation (The liability of the executive officer; Dr. Zoltán Csehi, Dr. Marianna Szabó (eds.): Wolters Kluwer Kft., p. 141).

dure, the company's director – including the director deleted from the company register prior to the involuntary dissolution procedure – is liable for creditors' unsatisfied claims up to the amount of damages caused if, after the threat of insolvency has arisen, they carried out their management duties without taking the creditors' interests into account, thereby resulting in a decrease in the company's worth or the failure to satisfy the creditors' claims." Although my intention in this paper is to deal exclusively with the liability of the director according to Section 33/A of the Bankruptcy Act, observations connected to threatening insolvency are also implicitly authoritative with regard to Section 118/B of Act V of 2006.

Section 33/A of the Bankruptcy Act, as the legal regulation which enables directors' underlying liability for damages to be determined to the detriment of their own assets, states under paragraph (1) that: Any creditor or the liquidator – in the debtor's name – may bring action during liquidation proceedings for the court to *establish* that the former directors of the company under threat of insolvency failed to fulfil their management tasks by taking into account the interests of creditors in the span of three years prior to the initial date of liquidation proceedings and in consequence of which the company's assets diminished, or they failed to provide full satisfaction of creditors' claims, or neglected to clean up environmental damage. Any person with actual power to influence the decision-making mechanisms of the company shall be considered a director of the company. If damage is caused by several persons together, their liability shall be joint and several. A situation carries the potential threat of insolvency as of the date when the directors of the company were – or should reasonably have been – able to foresee that the company will not be able to satisfy its liabilities when due.

(6) Within a 60-day limitation period following announcement in the *Company Gazette (Cégközlöny)* of the decision concluding the liquidation proceedings, any creditor may bring action for the court to establish the liability of the debtor's former director under paragraph (1), and hence to *obligate* this director to satisfy the debtor's claim to the extent of its claims not yet satisfied. If within the said time limit more than one creditor has filed for action, the court shall consolidate these actions and satisfy the creditors' claims proportionately. If a final decision in the lawsuit under paragraph (1) is not adopted by the final conclusion of liquidation proceedings, the 60-day limitation period shall begin on the day following the day when the final court ruling in the lawsuit is adopted.

(7) If, based on the interim balance sheet and partial proposal for the division of assets approved by the court, the assets of the debtor covered by liquidation proceedings are insufficient to satisfy the creditors' claims, any creditor or the liquidator – in the debtor's name – may also bring action for the court, under the procedure in paragraph (1), to obligate the debtor's former director under paragraph (1) to settle any claim not yet satisfied.

Before analysing the legal regulations themselves, I think it necessary to determine in simplified terms the personal scope of the liquidation procedure, thus aiding interpretation of Section 33/A of the Bankruptcy Act. The *debtor* is the economic entity under the process of liquidation (in the majority of cases a company). The *creditor* is the person possessing a financial claim against the company under liquidation, which they have declared to the liquidator. (The creditor's claim must be declared within a 40-day deadline of the announcement of the liquidation proceedings, but at the latest within a 180-day limitation period, on payment of a 1% registration fee.) With respect to the *director*, given that companies are the most frequent subjects of liquidation proceedings, the overwhelming majority of cases entail the liability of the managing director of a private limited company (Kft.) or the members of the board or chief executive of a joint-stock company (Rt.). The concept of the director belongs to company law and must not be confused with the concept of an employee in a managing position under the Labour Code, although the two may coincide. The Bankruptcy Act is also able to establish the liability of so-called shadow directors, persons not recorded in the company register as directors who nevertheless exercise a decisive influence on the operation of the company.

The emergence of threatening insolvency represents a dividing line in the context of the director's liability, because it is from this point on that the director is obliged to carry out their management tasks based on *the primacy of creditors' interests*, and no longer those of the company. With the introduction of Section 33/A of the Bankruptcy Act, Hungarian lawmakers further refined the rules on liability applying to directors, adopting the legal principle known as wrongful trading (entailing undue risk-taking) in order to prevent the management of a company, in a situation approaching bankruptcy, from taking any unwarranted risk injurious to the interests of creditors.[8] The justification for the introduction of this legal protection for creditors was that any businessman managing responsibly should be expected to continue to operate the company under their control once a threat of insolvency arises without endangering the prospects of creditors recovering their claims. In instances such as this, the managing director – if not initiating the bankruptcy or liquidation proceedings – should endeavour at every step to ensure that creditors' claims are satisfied. The preamble attached to Section 33/A of the Bankruptcy Act states that the liability of the director is formulated in favour of the creditors, in so far as the management tasks at a company under the threat of insolvency have been carried out in a negligent and unlawful manner resulting in damage to the company's creditors.

8 Pécs Court of Appeal, ruling no. Pf.IV.20.470/2013/15.

The goal of the aforementioned Section 33/A of the Bankruptcy Act is to establish the *underlying liability for damages under civil law* towards creditors that applies to the director of an economic entity and extends to their own private assets in the event that, in a situation threatening insolvency, they fail to carry out their management tasks based on the primacy of creditors' interests, bringing a reduction in the company's worth as a consequence. *This is an extraordinary form of liability applying to directors, who may only be compelled to pay compensation to creditors on the basis of their liability in the event that unsatisfied creditors' claims remain following the liquidation procedure.*[9]

My view is that Section 33/A of the Bankruptcy Act is the most complicated legal provision regulating liability under economic law, one which practicing economic lawyers are often unable to interpret or manage. If the creditor takes the view that some action, omission or transaction by the director, carried out after the threat of insolvency had arisen, injured the primacy of creditors' interests, then they may initiate a lawsuit against that director even while liquidation proceedings are under way. In this lawsuit, the court will (only) determine in its ruling the amount of the decrease in the company's assets caused by the director's actions. In this suit, the court will rule on the legal grounds and amount of the director's liability, and conduct the necessary evidentiary procedures accordingly. "In the declaratory proceedings, the establishment of liability, and the consequent determination of the amount of this liability, represents only the upper limit of the established liability (pro viribus liability)." In this suit, the court "rules on the preliminary issue of the highest amount which it may subsequently order to pay on legal grounds."[10]

A suit for damages compelling the director to pay actual compensation to the creditor does not take place if the creditor's claim has been recovered during the liquidation procedure, although the practical likelihood of this tends to be close to zero as claims in liquidation proceedings by creditors who are not covered by contractual guarantees are very rarely recovered. The creditor may thus initiate a separate suit for damages against the director – meaning that the court may compel the director to pay compensation to the creditor – only once it is verified that the creditor's claim has not been recovered during the liquidation proceedings. The general rule is that a suit for damages against the director may be initiated once the liquidation procedure is complete, but Section 33/A, paragraph (7) of the Bankruptcy Act also provides the creditor with the option of initiating a suit on completion of the interim balance sheet approved by the court, provided this can be used to establish that the liquidated assets are insufficient to satisfy creditor claims. In a suit for damages, the court will compel the debtor's director to pay an

9 Budapest Court of Appeal, 13.Gf.40.002/2012/15.

10 Debrecen Court of Appeal, Pf.II.20.390/2011/3.

amount of compensation of at most the amount of the reduction in the company's worth determined in the ruling from the earlier declaratory proceedings. Provided the amount of the claim by the creditor initiating the suit not satisfied under the liquidation procedure does not exceed the previously determined reduction in the company's worth, the court will compel the director to pay compensation only of the amount corresponding to the creditor's claim. If the suit for damages is jointly initiated by several creditors, then the court will compel the director to pay compensation to each and every creditor (proportionate to the creditors' individual claims); however, the total amount of compensation to be paid may not exceed the amount of reduction in the company's worth determined at the earlier declaratory proceedings, so that this represents the upper limit of the director's liability for damages. The declaratory proceedings are not, therefore, necessarily followed by a suit for damages, but if they are, then the claim preferred by the creditor therein will not necessarily match the amount of lost assets determined in the declaratory proceedings. For this reason, the liability of the director is underlying and subsidiary, applying exclusively to claims not satisfied from the debtor's liquidated assets which might have been satisfied had the director not violated the regulations guiding their actions.[11]

Section 33/A of the Bankruptcy Act does not regulate liability for the occurrence of a situation threatening insolvency, and on this basis *the director has no obligation towards the company's creditors to accept any responsibility for the emergence of the insolvency threat.* Instead, Section 3:112, paragraph (2) of the Civil Code provides the basis for the director to answer to the company for triggering the insolvency situation, for their conduct prior to the insolvency arising, for their economic activity preceding this, and for the loss of assets incurred. Consequently, only a loss of assets after the threat of insolvency has come about, and only conduct by the director in the ensuing period which leads to failure to satisfy creditor claims or causes a deterioration in the company's worth, may provide a basis for the establishment of liability for damages pursuant to Section 33/A of the Bankruptcy Act.[12]

When it can already be seen that insolvency will occur in future and a threat of liquidation has arisen, from this point onwards the director must ensure "the unity and integrity of remaining assets." "The task of the managing director during this period is to preserve and not reduce the worth of the debtor company, and to maintain the integrity of the assets serving to cover claims from creditors."[13] The director's liability can be established in the event that, in the period following the onset of the insolvency threat, the assets of the debtor company decrease in

11 Budapest Court of Appeal, 13.Gf.40.002/2012/15.

12 Pécs Court of Appeal, Pf.IV.20.470/2013/15.

13 Budapest Court of Appeal, 12.Gf.40.746/2013/7

a way that "they thereby become assets subject to liquidation of a smaller extent and value, since this will cause actual injury to the interests of all creditors in the liquidation process."[14] The obligation to preserve the unity and integrity of assets does not mean that the director must discontinue any economic activity. In a situation threatening insolvency, the director may continue to pursue the company's economic or production activity unchanged, continuously disburse wages, debts to suppliers and loan repayments, order goods and so forth, but *must refrain from concluding any transactions that entail heightened risk* (e.g. extending loans to third parties without contractual guarantees). The director must strive to conclude transactions and "supervise the operations of the economic entity with an acceptance of risk which might bring the company rapid revenue or profit, and must take all necessary measures to ensure that the company settles its debts."[15] If the director assumes any undue risk, and thereby causes a decrease in the company's worth in terms of the assets that can be turned toward satisfying its creditors, then liability for damages may be established.

According to the facts of lawsuit no. Gf.IV.30.117/2013/8 heard by the Pécs Court of Appeal, the managing director informed members of the private limited company at the members' meeting of the debtor company that the lessor had had the company's warehouse and business premises closed due to unpaid rent, and would not release the stock of goods or allow access to it, so that the company was unable to continue operation, and the debtor was unable – without the distribution of goods, and consequent turnover and revenue – to either pay wages or settle invoices to suppliers. The members' meeting resolved by unanimous vote that the managing director would give the company's employees their notice. At the start of the liquidation process, the assets of the private limited company under liquidation (debtor) totalled HUF 5,907,000, consisting of HUF 3,000 in cash, HUF 2,746,000 in receivables, HUF 409,000 worth of tangible assets, and inventory valued at HUF 2,749,000. The inventory stored in the locked warehouse by the lessor was released to the liquidator, who managed to collect a total of only HUF 160,000 proceeds from it, given that it had accumulated over a period of 15 years and consisted of unsaleable and faulty stock. In the suit launched by the creditor as plaintiff against the managing director as defendant, the court rejected the claim on the grounds that the plaintiff could not prove a loss of assets, since the company's worth had not decreased as a result of the defendant's conduct. The lessor handed over the inventory held in the leased facility to the liquidator, and this inventory came into the liquidator's possession in the same condition and quantity prior to the liquidation procedure, so that – in the absence of a loss in assets – there was no question of the defendant being held liable under Section 33/A

14 Budapest Court of Appeal, 15.Gf.40.503/2014/8.

15 Budapest Court of Appeal, 10.Gf.40.037/2013/3.

of the Bankruptcy Act. The Court of Appeal noted that, in principle: "The fact that the defendant did not continue operations after the threat of insolvency arose cannot be evaluated as an aspect of the case establishing the defendant's liability. At the time of the rented facility's closure, the company held no liquid assets. *In the absence of company assets, the managing director cannot be compelled to continue to operate the company, and neither can the director be expected to cover operating costs from their own funds.*" The plaintiff also wrongly alluded to the defendant having harmed creditors' interests when the member's loan it provided was not used to satisfy creditors or pay rental fees. "Up until the start of liquidation proceedings, it is the director who decides which creditors are to be paid off, if – at the point the threat of insolvency arises – they no longer have the liquid assets at their disposal needed to pay off all claims preferred against the company."

In a situation threatening insolvency, in the practice of the courts it is an expectation – moreover, an explicit obligation – of the company's director to convene a members' or general meeting of the company for the reasons designated in the Civil Code. Section 3:189 of the Civil Code states that the director of a private limited company is obligated to convene the members' meeting without delay in order to take necessary measures if they become aware that the company's equity has decreased to half of the initial capital as a result of losses; based on Section 3:270 of the Civil Code, the board of directors of a joint-stock company is obligated to convene the general meeting within eight days if equity decreases to two-thirds of the share capital as a consequence of losses. The director must still convene the members' meeting – and the board of directors the general meeting – if the company is threatened with insolvency or has stopped making payments; or if its assets do not cover its debts.

## 3. EXAMINING THE OCCURRENCE OF A SITUATION THREATENING INSOLVENCY

### 3.1. Instances of insolvency under the law

A situation threatening insolvency necessarily precedes the actual onset of insolvency. Before examining the situation threatening insolvency, I think it justified to briefly review the causes of insolvency. Section 27, paragraph (2) of the Bankruptcy Act deals with the reasons for ordering liquidation proceedings, which are thus the causes of the insolvency itself. Under the liquidation proceedings launched at the request of creditors, the court shall declare the debtor insolvent:

*a)* upon the debtor's failure to either settle or contest its previously uncontested and acknowledged contractual debts within 20 days of the due date, and failure

to settle such debt upon subsequent receipt of the creditor's written payment demand, or

*b)* upon the debtor's failure to settle its debt within the deadline specified in a final court decision or payment summons, or

*c)* in the event of an unsuccessful enforcement procedure against the debtor, or

*d)* if the debtor did not fulfil its payment obligation as stipulated in the composition agreement concluded in bankruptcy or liquidation proceedings, or

*e)* if the court has terminated the preceding bankruptcy proceedings [Section 18, paragraph (3); Section 18, paragraph (10); or Section 21/B].

*The creditor may initiate liquidation proceedings on the basis of the company's liquidity.* The liquidating court cannot scrutinize the debtor's economic situation, nor hear evidence in this regard. "The Bankruptcy Act applies a concept of insolvency from a cash-flow perspective, and is indifferent to the debtor's assets when judging insolvency."[16] The concept of insolvency does not give the court the opportunity to examine whether the debtor has lost their assets, is permanently insolvent, or – due to the impossibility of recovering receivables – is merely struggling with temporary liquidity problems.[17] Consequently, there is also no way of taking into account – in the expected event of a favourable result for the creditor in the suit for recovery of its claim – whether the debtor will be able to satisfy the creditor's claim from liquid assets it is able to recover. The cash-flow perspective of the Bankruptcy Act does not determine insolvency from the point of view of a lack of assets – or, more precisely, the lack of assets is not a reason for insolvency. Under the liquidation proceedings initiated by the creditor, *the court cannot examine whether the assets of the debtor* (moveable or immoveable assets and receivables) *exceed its liabilities.* (This is only possible in liquidation proceedings initiated by the debtor or liquidator.[18]) The court's options for scrutiny are confined exclusively to examining whether the debtor disputed its debt, giving reasons in a statement in writing within the given deadline; whether – after completion of the lawsuit – it complied with the court's judgement and order to pay within the deadline for fulfilment; and whether any enforcement procedure launched against the debtor is proven to have failed.

---

16 Debrecen Court of Appeal, Pf.II.20.390/2011/3.

17 BH 2001. 392.

18 According to Section 27, paragraph (2), point f) of the Bankruptcy Act, the court will order liquidation if, in proceedings initiated by the debtor or by the liquidator, the debtor's liabilities exceed its assets, or if the debtor was unable and presumably will remain unable to settle its debt (or debts) on the due date, or if in proceedings opened by the liquidator the members (owners) of the debtor company fail to provide a statement of commitment – following due notice – to guarantee the funds necessary to cover such debts when they fall due.

There is a conspicuously large gulf between the causes of insolvency. The debtor still qualifies as insolvent even if it has not settled its contractual debt within 20 days of the due date and has not disputed this debt, and has also failed to settle the debt when the creditor has subsequently made a demand in writing, and also when the enforcement procedure carried out against it based on a final court judgement has proven unsuccessful. In so far as the aforementioned causes of insolvency apply, the court will order liquidation irrespective of whether the amount of debts actually exceeds assets, a factor that the court will not scrutinize.

Given that Hungarian lawmakers adopted the concept of director's liability contained in Section 33/A of the Bankruptcy Act from the UK model (wrongful trading defined under Section 214 of the Insolvency Act 1986), as a matter of interest I will briefly touch upon the UK regulation.

In the UK, the causes of insolvency are defined under Section 123 of the Insolvency Act 1986. A company – among other reasons – is deemed insolvent:

- if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due[19] ("cash-flow" test), or
- A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities ("balance-sheet" test).[20]

The cash-flow test, otherwise known as the commercial insolvency test, is a flexible tool for determining the criterion of "when debts fall due," the essential interpretation of this concept being noted by the High Court of Justice in the case of *Cheyne Finance Plc (in receivership) [2007] EWHC 2402 (Ch)*[21], using the following example: "The company has £1,000 ready cash and a very valuable but very illiquid asset worth £250,000 which cannot be sold for two years. It has present debts of £500, but a future debt of £100,000 due in six months. On any commercial view the company clearly cannot pay its debts as they fall due, but it is, or would be, balance sheet solvent. Insolvency may occur earlier than expected, as it may already be determined if a company is able to pay its present debts, but will not be able to settle some known future debt." This approach leads us to the Hungarian concept of a situation threatening insolvency.

19 Insolvency Act 1986, Section 123, paragraph (1), point (e).
20 Insolvency Act 1986, Section 123, paragraph (2).
21 http://www.bailii.org/ew/cases/EWHC/Ch/2007/2402.html - date of download: 15 October 2015.

### 3.2. The concept of a situation threatening insolvency in the practice of the courts

With the emergence of a situation threatening insolvency and altering liability (otherwise known as a threat of insolvency), the director must thus proceed no longer on the basis of primacy of the company's interests, but rather by taking into account the interests of creditors, and for this reason any procedure which results in injury to the company's creditors qualifies as wrongful trading. Prior to examining any decrease in assets caused by the director in the liability suit initiated under Section 33/A of the Bankruptcy Act, as well as specific transactions, measures, omissions or procedures carried out by the director causing injury to the interests of creditors, the plaintiff preferring the claim must primarily prove when exactly the situation threatening insolvency arose, since it is only the conduct displayed by the director from this point in time that may serve as the basis for establishing liability as regulated under Section 33/A of the Bankruptcy Act.[22]

First and foremost, we must particularly emphasise the difference between the legal and economic context of a situation threatening insolvency. In lawsuits brought by creditors, directors will typically argue in their defence that when the act they are charged with was committed, or the contested transaction concluded, a situation threatening insolvency had not arisen because the debtor's total assets were sufficient to cover payment of its debts. In certain legal proceedings the accountants of the debtor company may also be heard as witnesses, who – taking an economic approach – will likewise declare that the debtor was not in a situation threatening insolvency because the value of the debtor's receivables, tangible assets, inventories and invested assets exceeded the total amount of liabilities due. This approach is correct in as far as the concept of assets under civil law and accounting law includes all assets (as well as liabilities), be they liquid or illiquid elements, invested or current assets alike. However, in the concept of a situation threatening insolvency under *bankruptcy law* – as described in detail in the following point – the debtor's illiquid assets that cannot immediately be converted into cash (invested assets) must be disregarded when judging whether the threat of insolvency has come about, and only liquid asset elements serving to cover due debts (including primarily freely available cash) can be taken into consideration.

Cited in an increasing number of rulings and fulfilling a guiding role in the practice of the courts, the decision of the Curia reached in case no. Gfv.VII.30.247/2013 (published under no. BH 2014. 188), in interpreting the legal provision in question, set out the supreme court's current standard position on judgements in this regard, at the same time defining a concise notion of the situation threatening insolvency, according to which: "*Threatening insolvency occurs when the debtor*

22 Published ruling no. IH. 2013. 38.

*cannot foreseeably settle its debts by the due date."* And: *"Regarding the possibility of establishing a situation threatening insolvency, the essential question is whether the debtor will be able to settle its debts by the due date."*

According to the facts of the case, in its judgement in a lawsuit dated 26 January 2009, the court compelled the private limited company – then not yet under liquidation – to pay the plaintiff HUF 3,659,982 and default interest calculated from 26 March 2007, a judgement which was upheld by the court of second instance in its ruling dated 17 June 2009. The plaintiff's prompt collection order (issued based on the judgement) was unsuccessful. The plaintiff petitioned for liquidation against the private limited company (debtor) on 5 October 2009, and the court duly ordered liquidation proceedings, beginning 25 March 2010. The liquidation process saw 16 creditors lodge claims for a total of HUF 38,331,609. The defendant director established I. Kft. – with his wife and son – on 11 January 2010, and this new company invoiced an entrepreneur's fee of EUR 57,780 for work ordered by its contracted partner on 12 July 2009 and completed by the debtor in the period between 11 November 2009 and 18 April 2010. Granting the plaintiff's suit under Section 33/A of the Bankruptcy Act, the court of first instance determined in its judgement that the defendant, following the onset of the situation threatening insolvency, failed to fulfil their management tasks based on the primacy of creditors' interests, thereby leading to a decrease in the debtor's assets by the amount of EUR 57,780. The court established that the threat of insolvency existed at the latest by 17 June 2009, i.e. when the earlier ruling for damages in the second instance against the debtor was made. According to the court, at this time not only a situation threatening insolvency, but actual insolvency could already be established at the company, given that – under Section 27, paragraph (2) of the Bankruptcy Act – grounds for ordering liquidation proceedings against a company arise "upon the debtor's failure to settle its debt within the deadline specified in a final court decision" or "in the event of an unsuccessful enforcement procedure." Based on the defendant's personal decision, therefore, the new company under his management realized the EUR 57,780 entrepreneur's fee. The judgement in the first instance was upheld by the Budapest Court of Appeal in its ruling no. 15.Gf.40.172/2013/6, while the Curia left the final ruling in force. In the reasoning for the judgement, the following should be highlighted: Under Section 33/A, paragraph (1) of the Bankruptcy Act, a situation carries the potential of threatening insolvency as of the date when the directors of the company were – or should reasonably have been – able to foresee that the company will not be able to satisfy its liabilities when due. "For a situation threatening insolvency to arise there is no need for the court to establish the debtor's insolvency or to order its liquidation, since the threat of insolvency is a state of affairs occurring prior to materialisation of the causes of insolvency (and liquidation) defined in the law. *Regarding the*

*possibility of establishing a threat of insolvency, the essential question is whether the debtor will be able to settle its debts by the due date. If unable to do so due to insufficient liquid assets or credit to pay off the debts, or if it is unable to reach agreement with creditors on an alternative method of settlement or amendment of the fulfilment deadline, then the situation threatening insolvency will come about even in the event that the debtor's other assets – on the basis of financial statements – would provide cover to satisfy its liabilities. The emergence of the threat of insolvency must be examined from the point of view of the awareness of the facts as they are knowable to the debtor's director. In order to avoid the threat of insolvency, the debtor's director should continuously monitor the company's due or overdue liabilities and its cash-flow statements. The significance of an emerging situation threatening insolvency is that while it persists the director must manage the company while serving the interests of creditors, and not by taking into account the interests of the company's owners. This obligatory management principle applies for as long as the situation threatening insolvency; in other words, for as long as the company is unable to satisfy its liabilities by the due date."* The defendant would have proceeded correctly as the debtor's director if he had settled the contractual portion performed by the debtor and accounted for the revenue received on this basis with the debtor. In acting as he did, still proceeding as the debtor's director and, in the debtor's name, diverting revenue from a partially already fulfilled contract to a newly established company, it can be established that the defendant did not proceed based on the primacy of interests of the debtor company's creditors.

With regard to the practice of the courts, the conclusion contained in ruling no. Gf.III.30.403/2014/8 of the Szeged Court of Appeal is also worth highlighting, whereby, in the event of a threat of insolvency, the essential question is whether the debtor is able to pay its debts by the due date.[23] "*The 'ability' to settle the debt at the due date assumes the existence of liquid assets, meaning that it is not sufficient if the debtor's total assets – when converted to cash – would otherwise provide cover to satisfy its liabilities.* The emphasis is on satisfaction by the due date: the debtor's director should therefore continuously monitor the company's due or overdue liabilities and its cash-flow statements. The director's freedom to make decisions extends to the order in which overdue debts are settled, but they may only do this for as long as it can be foreseen that the debtor's liquid assets will provide cover for all overdue or imminently due liabilities."

*(to be continued)*

23 Published ruling no. BDT. 2013.47.