Directorships of Luxembourg companies: 
Duties, lessons from case law, and practical tips

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Thursday 22 March 2012
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Introduction
Introduction

• Each month c. 500 new Luxembourg companies registered (Source: RCS)
• Estimated 1500 "new" directors per month (assuming 3 directors per company)
• Different nationalities and professional backgrounds
• How aware are they of their duties and responsibilities under Luxembourg law?
• Basic and common-sense principles: Act reasonably, with diligence, in the interests of the company, etc
• But there may be significant differences between Luxembourg law and, for example, American law
• And a simple principle can be surprisingly complicated to apply in practice
• The devil is in the detail…
Introduction (Contd.)

• Lessons:
  – Be aware of risks and anticipate risks
  – Understand the type of risk and its timing
  – Endeavour to anticipate / know how to react to potential gazelles

• In 2011 Allen & Overy conducted a survey together with Willis – "Directors in Peril: Insurance and indemnity in risky times"
  – 20% of respondents had experience of a claim or investigation in respect of directors
  – Surprising given the perception of a relatively benign litigation environment
Introduction (Contd.)

• Relatively few published cases in Luxembourg on directors’ liability

• Nevertheless:
  – There are some cases / substantial case law in Belgium and France (and elsewhere)
  – Published cases are the tip of the iceberg – arbitration (confidential) / contractual settlement of claims / threats short of formal claims / indemnities and insurance claims settlement
Introduction (Contd.)

• What we will not be covering in our talk (this time):
  – Regulated entities
  – Listed companies
  – Differences between SAs, Sàrls and other forms of companies in detail
  – Distressed situations and insolvency issues
  – Liability and business licenses or other licenses
Introduction (Contd.)

• Relevant sources include:
  – Statute
    • Law of 1915 on Commercial Companies, as amended (the *Companies Act*)
    • Civil Code
    • Commercial Code
    • Criminal Code
    • Tax Code and other codes/specific legislation
  – Contract
    • Articles of association
    • Shareholders agreement
    • Directors’ agreement / executive directors - employment contract
    • Other contractual arrangements, e.g. domiciliation agreement / management agreement
  – Case law
  – Academic writing
  – Best practice / *soft* law
Powers and duties
Powers

• Broad in scope:
  – Any action necessary to realise corporate object, except where expressly reserved by law / articles of association to shareholders

• Some practical examples of powers:
  – Power to bind the company towards third parties; entering into contracts on behalf of the company
  – Interim dividends (provided articles of association permit)
  – Issuance of shares within authorised share capital

• Powers do not include matters expressly reserved by law / articles of association to shareholders:
  – For example, statutory approval of annual accounts, and appointment and removal of directors
Powers (Contd.)

- Powers may be expressly limited:
  - By articles of association
    - object of the company
    - provisions dealing with internal and external management
    - effect on third parties
  - Contractually, e.g. through an applicable shareholders agreement, or external finance documents
  - By a resolution of the board

- Directors going beyond the scope of their powers run the risk of personal liability or contractual claims
To what extent can the powers be delegated?

- Day-to-day management can be delegated
  - Administrateur délégué
- Committees can be established (e.g. nomination; remuneration)
- Delegation of signing authority is possible for specific documents
- Delegation is possible for specific acts or groups of acts, and powers of attorney may be entered into
- However, the board retains overall responsibility, and responsibility for the decision to delegate – the delegation must be considered, reasonable and in the company’s interests
- A power of attorney runs the risk of being void if too vague
Practical example - Powers

• LuxCo is wholly owned by Wewanttobebiggerthanapple Inc., a multi-national technology company
• LuxCo was incorporated 5 years ago, and has become increasingly active in relation to intra-group treasury activities
• Since incorporation, no face to face board meeting has taken place
• Formal resolutions have been passed once, by circular resolution
• That circular resolution delegated all power to negotiate and sign all contracts to any combination of employees of Wewanttobebiggerthanapple Inc.
• Material contracts are sourced, negotiated and signed by employees of Wewanttobebiggerthanapple Inc. in the U.S., including multi-million euro loans to other group companies, and guarantees in favour of external finance providers
• The corporate object of LuxCo is poorly drafted, and does not expressly include treasury activities or the giving of loans or guarantees
Basic duties and standard of care

- Pre-appointment "duty" to understand, and consider suitability for, directorship
- Duty to comply with the Companies Act and the company’s articles of association
- Duty not to do anything which falls outside the company’s corporate object
- Duty of confidentiality
Basic duties and standard of care (Contd.)

• Duty to manage the company’s business in good faith, with reasonable care, in a competent, prudent and active manner

• Competence and prudence…

• Duty to act with the standard of care and diligence that a reasonable director would exercise

• Duty to stay informed

• Duty to prepare and make a fair presentation of annual accounts in accordance with Luxembourg legal and regulatory requirements relating to the preparation of the annual accounts and responsibility for internal controls as the Board of Directors determines are necessary to enable the preparation of annual accounts that are free from material misstatement
Basic duties and standard of care (Contd.)

• Duty to act in the best corporate interest of the company:
  – N.b. Security and guarantees granted to secure the obligations of a parent or sister company
  • Belgian case law: (i) corporate object needs to permit; (ii) company needs to derive an arm’s length benefit (e.g. more advantageous terms secured by group, with indirect but identifiable benefit to company); and (iii) not disproportionate to the company’s means and the benefits to be derived (e.g. limited recourse clause)

• Contractual obligations (e.g. directors contract / shareholders agreement)

• Employment law if employee
Basic duties and standard of care (Contd.)

• Duty to avoid conflicts of interest
• Duty to disclose to board and ensure properly recorded in minutes
• "Conflict of interest":
  – Personal, financial, direct or indirect interest that conflicts with that of the company
  – Not applicable to decisions relating to daily management
  – Directorship of shareholder or another group company does not, *per se*, create a conflict
• Impact on quorum
• May not take part in deliberations
• At next general meeting, "special report"
• No express application of statutory procedure to Sàrl
Practical example - Duties

• Joe is a director of 30 Luxembourg holding companies

• His directorships include:
  – Holding companies of Whoareappleanyway Inc. and Thoughtactivatedphones Inc., two competitors in the technology industry
  – Algorithms Bank SA, owned by funds managed by Rocketscience Partners
  – A holding company of Definitelyprivateequityabsolutelynotahedgefund Partners which holds 100% of Waveenergyinthesahara Inc., a major portfolio company
Potential liability and lessons from case law
Civil liability

- **PRINCIPLE**
  - Art. 58 Companies Act
  - Liability limited to the assets of the company, i.e. no personal liability
  - Directors not liable for the obligations of the company

- **EXCEPTION**
  - Art. 59 Companies Act and Art. 1382 Civil Code
  - Directors responsible for the due performance of their duties and personally liable for mismanagement
  - Directors may be liable towards the company and / or towards third parties depending on the type of liability
Misconduct of management

• Art. 59 paragraph 1 of the Companies Act
• What is the expected behavior of a director?
• Assessment *in abstracto* BUT in the circumstances that are known or should have been known at the time of disputed events/decisions - Obligation to make inquiries
• Impact of remuneration, sophistication/experience, age, family relationships, good faith?
• Who can exercise action?
  – Only the company after decision of general meeting of shareholders
  – Liquidator or insolvency administrator
  – Creditors on the basis of an *action oblique*
• No action by individual shareholder? Immunity for directors appointed by majority shareholders? Draft Bill No.5730?
• Possible joint and several liability?
Misconduct of management (Contd.)

Examples derived from case law:

- Hasty investment decisions without appropriate guarantee
- Entering into important contracts on terms detrimental to the company
- Not providing for adequate insurance
- Not pursuing the payment of debts due to the company
- Making important payments that are not (yet) due
- Lack of supervision of the daily managers or accountants
- Financing entities out of the money
- Filing for insolvency without authority
Breach of Companies Act or articles of association

- Art. 59 paragraph 2 of the Companies Act
- Who can exercise action?
  - Company
  - Third parties
- What about individual shareholder?
- Court of Appeal, 30 November 2011, No. 36253
- Contractual versus tort liability? Impact?
- Presumption of joint and several liability
- How to rebut presumption?
  - Director should not take part in the breach
  - Director should report breach to the first general meeting after he / she / it has acquired knowledge thereof
    - obligation to request the convening of such meeting?
    - District Court, 15 July 1993, No. 40.594
Breach of Companies Act or articles of association (Contd.)

Examples derived from case law:

- Violation of signing authority rules
- Violation of conflict of interest rules
- Violation of object clause
- Failure to submit on a timely basis the annual accounts
- Failure to convene a shareholders' meeting if required by law
Liability in tort

• Art. 1382 and Art. 1383 of the Civil Code, last recourse remedy?
• Fault, any deviation from general standard of good behaviour? Action and inaction?
• Who can exercise action?
• Strong reluctance from Luxembourg courts to hold directors liable towards third parties for misconduct of management:
  – District Court, 6 December 2006, Bull. Dr. Banque, No. 41
  – District Court, 29 June 2007, No.104787
  – District Court, 28 November 2007, No. 98585
  – District Court, 24 October 2008, No. 84529 and 106650
Liability in tort (Contd.)

• Examples derived from case law:
  – Manifestly unreasonable continuation of an activity running at a loss
  – Exercising competing activities
  – Retroactive attribution of remuneration without basis where company is in financial distress

• Shadow directors
  – Definition? Court of Appeal, 10 July 2002, No. 23054, 24097, 26382
  – Tort or contractual liability?
  – Interaction between shareholders and directors – Art. 53 versus Art. 67 Companies Act
  – Drafting shareholders agreements - Guidelines
Criminal liability

• No liability without specific legislation
  – Art. 163-173bis Companies Act
  – Criminal Code
  – Other laws

• Liability of legal entities
  – Crime or offence committed by one of its legal bodies or by its legal or de facto managers on its behalf and in its interests
  – Criminal responsibility incurred by legal entities will also apply to natural persons who are authors of or accomplices to the crime or offence
  – Sanctions: (i) fines; (ii) special confiscation; (iii) withdrawal of participation in a public procurement contract; and (iv) dissolution
Criminal liability (Contd.)

Recent case law:

• Liability of legal entities:
  – District Court 24 March 2011 No. 1076.2011
  – District Court 15 March 2011 No. 923.2011

• Publication of accounts:
  – Court of Appeal, 12 July 2011, No. 380.11
  – Court of Appeal, 6 July 2010, No. 307.10, further to Cass., 25 February 2010, No. 10.010 and 11.010
  – Court of Appeal, 6 November 2001, No. 375.01
Mitigating risks

- Discharge – Art. 74 Companies Act
- *Ad hoc* approval - Art. 67 Companies Act
- Insurance
- Indemnity letter
- Limitation of liability provisions
- Time limitation - Art. 157 Companies Act
Mitigating risks (Contd.)

- Investigation
  - Art. 64-4 Companies Act
  - Court of Appeal, 10 July 1991, No. 10974

- Recording objections
  - District Court, 21 January 1988, No. 37823; Court of Appeal, 10 July 1991, No. 10974
  - Art. 66 Companies Act - Board level versus shareholders level

- Delegation?
- Corporate directors? – Art. 51bis Companies Act
- Resignation?
Personal liability of Directors / Managers with respect to the payment of taxes due by the company
Personal liability of Directors / Managers with respect to the payment of taxes due by the company

• Key risk
  – Possibility for the tax administration to hold the Directors/Managers in charge of the daily management personally liable for the payment of the company’s taxes

• Legal basis
  – The *Abgabenordnung* (AO), which contains provisions of general nature applying to any type of tax (Art.103 et seq. AO)

• Conditions
  – Non-payment of any type of taxes
  – Resulting from a faulty breach by the Director / Manager of his/her duty to pay taxes due by the company from the company’s funds (Art.103 AO, Art.109 AO)
  – No need to take prior legal action against the company (joint liability) or for the company to be insolvent (Art.118 AO, Art.7 StAnpG)
Personal liability of Directors / Managers with respect to the payment of taxes due by the company (Contd.)

- **Persons concerned**
  - Directors / Managers *de jure or de facto* (shadow Directors) in charge of the daily management (Art. 103 AO, Art. 108 AO)
  - Directors / Managers who have ceased their functions remain personally liable for any faulty non-payment of taxes which occurred during their mandate (Art. 112 AO)
  - Newly appointed Directors / Managers are liable for non-payments which occurred prior to the start of the mandate of the Directors / Managers and of which the Directors / Managers are made aware of
  - Discretionary choice of the tax administration in case multiple Directors / Managers may be held responsible for the same facts (all, several or a single Director / Manager only) (Art. 118 AO, Art. 2 & Art. 7 StAnpG)
Personal liability of Directors / Managers with respect to the payment of taxes due by the company (Contd.)

Concept of faulty breach

- Recent case law covers both active (fraud and simulation) and passive (unjustified and deliberate inexecution) misbehaviors of Directors / Managers resulting in a non-payment of taxes due by the company.

- The personal liability has to be distinguished from the penalties incurred for fraud (Art. 396(1-4) AO: penalty equal to four times the amount of the fraud) and aggravated fraud (Art. 396(5) AO: a criminal offence punished by 5 years of imprisonment and a penalty of up to ten times the amount of the fraud, when the latter reaches significant amounts).

- Fraud is characterized when the tax liability of the company is intentionally reduced (by e.g. the use of artificial schemes) or when tax benefits are unduly granted to a company pursuant to false declarations by the Director / Manager.

- Consequently, the concept of faulty breach has a wider scope than that of fraud.
Personal liability of Directors / Managers with respect to the payment of taxes due by the company (Contd.)

Case law examples

- *Tribunal administratif du Grand-Duché de Luxembourg, 19 April 2010, No. 25874*, fraud existed as the manager had set up an artificial structure allowing the Company to declare only a part of the company’s profits. The tax administration considered this scheme as a hidden profit distribution taxable at the level of the company and, by virtue of §112 AO, held the manager liable for the payment of the corresponding taxes.

- *Tribunal administratif du Grand-Duché de Luxembourg, 30 January 2012, No. 28486*, the claimant was held personally liable for organizing to his own benefit the insolvency of a company of which he was the director and also the beneficial owner (notably by mortgaging the company’s assets to secure loans granted to a related company). This was not specifically a case of fraud, but this behavior characterized a faulty breach leading to a significant non-payment of taxes due by the company.
Personal liability of Directors / Managers with respect to the payment of taxes due by the company (Contd.)

Case law examples

– Cour Administrative du Grand-Duché de Luxembourg, 1 March 2012, No. 28891C) the Court held that the sole fact that, in the context of withholding tax on salaries and wages, the director had deliberately not paid the taxes due was sufficient to characterize a faulty breach. For instance, the defendant could not establish reasons that could have prevented him from exercising effective control over the company’s management. The fact that the company was financially in trouble was irrelevant, given the specific assessment of this tax
Practical tips
Practical tips

• Be informed:
  – Acceptance of position only if requisite level of expertise
  – Duty to keep up-to-date with and understand the affairs of the company
  – Understand the commercial and legal context and the structural and contractual set up - due diligence

• Board meetings:
  – Attend all board meeting if at all possible (important feature of duty of "diligence")
  – Hold face to face meetings rather than telephone meetings / use of written circular resolutions - ensure proper discussion and deliberation in board meetings
  – All relevant documents, including background (e.g. due diligence) reports, to be tabled and appended to minutes
  – Ensure proper minutes are produced and signed (although pros and cons of including greater detail)
  – Resist pressures from business people
  – Proper processes and delegation of authority in place
Practical tips (Contd.)

• Best practice particularly important where there is any threat or suggestion of insolvency / distress
• If there is such a threat, seek professional advice without delay, and take action to mitigate risk/ loss
• Consider seeking a “fairness opinion” or valuation or generally outside advice to support the Board’s decision
• Discipline
• No legal limit to the number of directorships that can be taken on, but can you as a Director / Manager comply with all your duties?
• Resignation (timing)?
Conclusion

• Good news: Good faith conduct of directors outside insolvency scenarios almost never leads to actual out of pocket liability

• Nominal liability can almost always be eliminated by a combination of indemnification, insurance, procedural rules and settlement incentives of plaintiffs, defendants and insurers

• HOWEVER: reputational risk

• Foreign tax laws should be monitored closely because there might be risks e.g. as a Director / Manager of a Luxembourg company which is a shareholder of a foreign company

• Foreign long arm legislation e.g. US legislation: Sarbanes-Oxley Act and FCPA
Conclusion

• Bad (?) news: transactional trends and macro-economic factors impact the role of directors and their potential liability
  – More joint ventures and co-investments
  – Role of independent resp. non-executive directors
  – Enhanced requirements for skill sets and permanent learning
  – Enhanced requirements for specialisation and diversity
  – Industry standards – good practices
  – More (pre-)insolvency events and hostile out-of-the-money creditors
  – Public finance in disarray -> more exposure to potential tax liability
Questions?

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