Liability of directors

1. Introduction

Starting a business of your own becomes increasingly popular. This comes with several advantages: you are able to organise your own time and to decide how many hours you want to work, you have the opportunity to put your mark on the company and entrepreneurship can be interesting from a fiscal point of view. However, what a lot of (future) entrepreneurs seem to underestimate, is that starting a company also comes with disadvantages and risks. When a company is founded in the form of a legal entity, entrepreneurs and directors often believe they are excluded from personal liability. This is not the case: the risk of directors' liability is always present.

1.1. Legal entity

When a legal entity is founded, a separate legal body with a legal personality is established. Based on article 2:5 Dutch Civil Code, a legal entity equals a natural person when it comes to property rights. This means that a legal entity can have the same rights and obligations as a natural person. A legal entity can therefore perform legal actions and for example enter into a contract, obtain property and debts or file a lawsuit. In order to achieve this, the legal entity needs help. The legal entity only exists on paper, it is not a physical person. Therefore, the legal entity cannot operate on itself, but has to be represented by a natural person.

1.2. Representation

The legal entity is represented by the directors' board.[1] Directors can perform legal actions on behalf of the legal entity. In principle, the director binds the legal entity with these actions and not himself. In this way, founders and directors can avoid that they become liable with their private assets. However, this cannot always be avoided. In certain cases, a director can be personally liable, possibly besides the legal entity. Most of the time this is the case in situations where severe accusations can be made towards the director concerning his functioning. There are two types of directors' liability: internal and external liability. Internal director's liability is liability of the director towards the legal entity. In this case, the director is held liable by the legal entity itself. External liability is liability towards third parties. In this case, the director is held liable by, for example, a supplier or a customer. In this paper, the grounds for directors' liability will be further discussed.

2. Internal liability of directors

Internal directors' liability derives from article 2:9 Dutch Civil Code. Based on this article, a director is compelled to a proper fulfilment of his tasks. When improper fulfilment of tasks is presumed, a director can be personally held liable by the legal entity. This derives from article 2:9 Dutch Civil Code. Article 2:9 Dutch Civil Code does not provide a clear description of the term 'improper fulfilment of tasks'. Further interpretation can therefore be found in case law. According to the Dutch Supreme Court, improper fulfilment of tasks will be assumed when a severe accusation can be made towards the director. This is now also included in article 2:9 Dutch Civil Code. This article states that a director is liable for improper management, unless no severe accusation can be made against him. The director may also not have been negligent in taking measures in order to prevent the occurrence of improper management. When do we speak of a severe accusation? This needs to be assessed by taking all circumstances of the case into account. In any event, the following circumstances need to be assessed:

[1] Though there could be other organs that represent the legal entity, such as the shareholders meeting, a supervisory board or a works council.

- the nature of the practised activities;
- the risks deriving from these activities;
- the division of task between the directors' board;
- any possible directives that apply to the directors' board;
- the information which a director held or should have held at the time of making decisions or taking actions;
- the insight and care that can be expected from a director.[2]

Acting contrary to the articles of incorporation of the legal entity is classified as a hefty circumstance. If this is the case, directors' liability will in principle be assumed. The articles of incorporation namely form the backbone of the legal entity. However, a director can bring forward facts and circumstances indicating that acting contrary to the articles of incorporation does not cause a severe accusation. In this case, the judge should explicitly include these facts and circumstances in his judgement.[3] In principal, the following acts cause improper fulfilment of tasks:

- extracting assets from the legal entity by using these as if they are private assets;
- mixing private matters with matters of the legal entity, competing with the legal entity and in particular subordinating the interests of the legal person to private interests or interests of third parties;
- the unauthorized binding of the legal entity to third parties;
- taking unnecessarily big financial risks, taking decisions that come with extensive financial consequences without proper preparation and entering into transactions that significantly extend beyond the financial resources of the legal entity, for example irresponsible several liabilities;
- not preventing or opposing undercapitalisation or a poor debt equity ratio and neglecting credit monitoring;
- not closing the usual insurances.

[2] ECLI:NL:HR:1997:ZC2243 (Staleman/Van de Ven).
[3] ECLI:NL:HR:2002:AE7011 (Berghuizer Papierfabriek).

2.1. Several internal liability and exculpation

As soon as improper management can be established based on article 2:9 Dutch Civil Code, all directors will in principle be severally liable. In this, the role of the director in the directors' board is not of importance. This derives from the sentence 'he is fully liable for improper management' in article 2:9 Dutch Civil Code. Severe accusations will therefore be made towards the entire directors' board. However, there is an exception to this rule. A director can exculpate from directors' liability. Exculpate literally means 'to excuse'. Article 2:9 sub 2 Dutch Civil Code indicates that exculpation consists of two parts. The director must demonstrate that the severe accusation cannot be held against him and he must demonstrate that he has not been negligent in taking measures in order to prevent the improper management.

2.1.1. Burden of proof in exculpation

A successful appeal on exculpation is not an easy task, because of the principle of collegial management. When a director only protested against the conducted policy of the directors' board, exculpation shall not be accepted. Directors must not take any decisions they do not support and should do everything within their power to limit the consequences of improper management as much as possible. De burden of proof in this lies with the director. A director can for example lay down in writing that he has warned for possible negative consequences and can record which measures he has taken in order to prevent these consequences. If a director in such a case is still not heard by his fellow directors, he may even be forced to resign in order to prevent liability.

2.1.2. Division of tasks within the directors' board

A division of tasks within the directors' board can be relevant on order to determine whether an individual director can be held liable. However, directors cannot simply exculpate just because they coincidentally had other tasks from the tasks that were improperly fulfilled. A director can be expected to be aware of all facts and circumstances that matter in taking decisions concerning the core activities of the organisation. Some tasks are considered tasks that matter to the entire directors' board, for example financial activities. A division of tasks

does not change this. Especially when a director depends on other directors in order to obtain certain information, he is expected to be critical and to ask his fellow directors for details about the facts and circumstances.[4] In principle, incompetence is not a ground for exculpation. Directors can be expected to be properly informed and to question certain information. However, there may occur situations in which this cannot be expected. In such a case, exculpation can be accepted.[5] Whether or not a director can appeal on exculpation depends for a large part on the facts and circumstances of the case.

3. External liability of directors

External liability entails that the director is not liable towards the legal entity, but towards third parties. External liability pierces the corporate veil. The legal wall of the legal entity is breached, as it were. The legal entity no longer shields the natural persons who are the directors. External directors' liability can occur within bankruptcy or outside bankruptcy. The legal grounds for external liability are article 2:138 Dutch Civil Code and article 2:248 Dutch Civil Code (within bankruptcy) and article 6:162 Dutch Civil Code (outside bankruptcy).

3.1. External liability of directors within bankruptcy

External liability within bankruptcy applies to private limited liability companies (the Dutch B.V. and N.V.). This liability derives from article 2:138 Dutch Civil Code (N.V.) and article 2:248 Dutch Civil Code (B.V.). These articles apply when a company goes bankrupt and creditors are left with unpaid claims. Usually, they could address the legal entity for payment of these claims, but because of the bankruptcy this is no longer possible. In principle, this is a risk that creditors are subject to when they give credit to other companies. However, this is not the case when the bankruptcy of a company is caused by mismanagement or mistakes of the directors' board. When a bankruptcy is filed, there is always a curator appointed. The curator represents all creditors after a company goes bankrupt. One of the tasks of the curator is to investigate whether or not directors' liability can apply. If that is the case, the directors of the

[4] ECLI:NL:RBMNE:2013:CA3225.
[5] ECLI:NL:GHAMS:2010:BN6929.

company can be held liable for the claims of the creditors. When improper management is established, external liability of directors can occur.

3.1.1. Apparent improper management

External liability can be accepted, based on article 2:138 Dutch Civil Code or article 2:248 Dutch Civil Code, when the directors' board has improperly fulfilled its tasks and this improper fulfilment is an important cause of the bankruptcy. In this case, every director is severally liable for the debts. The term improper management is of great importance. The burden of proof concerning this improper management lies with the curator. The curator must make plausible that a reasonably thinking director, under the same circumstances, would not have acted in this way.[6] The following actions establish improper management:

- taking part in fraudulent transactions;
- unlawful extraction of assets from the legal entity;
- making dividend payments contrary to the acts of incorporation of making dividend payments that are irresponsible, based on the resources of the legal entity;
- entering into transactions on behalf of clients, while insufficient guarantees or no guarantees at all are provided or asked;
- entering into obligations while it was reasonably known that the company could not comply with these obligations.

In all cases above, creditors are being impaired by the acts performed. A constant element within this case law is the prevention of abuse by directors.

3.1.2. Assumption of proof

Furthermore, the legislator has given the curator in article 2:138 sub 2 Dutch Civil Code and article 2:248 sub 2 Dutch Civil Code some tools in order to prove improper management. This are the so-called assumptions of proof. Based on article 2:10 Dutch Civil Code, the directors'

[6] ECLI:NL:HR:2001:AB2053 (Panmo).

board must keep a proper administration and based on article 2:394 Dutch Civil Code, the directors' board is also obliged to deposit an annual account. If the directors' board does not comply with these legal obligations, an assumption of proof arises. In this case, it is assumed that improper management has been an important cause of the bankruptcy of the company. This transfers the burden of proof from the curator to the directors. The Dutch Supreme Court has specified how the directors can disprove the assumptions of proof. In order to do so, the director must make plausible that not the improper management, but other facts and circumstances caused the bankruptcy. However, such a defence has to meet strict demands.

Improper management can exist of an act or an omission. A director can therefore also be held liable for being negligent in preventing the bankruptcy. This is the case when the cause of the bankruptcy came from outside. In this situation, the director must again demonstrate facts and circumstances that show that this negligence did not cause improper fulfilment of tasks.[7] Whether or not this defence will succeed depends on all circumstances of the case. Moreover, the curator can only file a claim in the period of three years prior to the bankruptcy. This derives from article 2:138 sub 6 Dutch Civil Code and article 2:248 sub 6 Dutch Civil Code.

3.1.3. Several external liability and exculpation

Based on article 2:138 sub 1 Dutch Civil Code and article 2:248 sub 1 Dutch Civil Code, every director will be severally liable for the debts of the company in case of apparent improper management. However, there is a way to escape this several liability. Just as we have seen with the internal liability deriving from article 2:9 Dutch Civil Code, directors can also exculpate themselves within bankruptcy. On the basis of article 2:138 sub 3 Dutch Civil Code and article 2:248 sub 3 Dutch Civil Code, a director will not be liable if he can prove that he was not responsible for the improper fulfilment of tasks by the directors' board. Furthermore, he may not have been negligent in taking measures in order to avert the consequences of the improper management.

[7] ECLI:NL:HR:2007:BA6773 (Blue Tomato).

3.1.4. Burden of proof in exculpation

The burden of proof in exculpation lies with the director. This derives from case law of the Dutch Supreme Court. In a particular case, a lower court determined that the cause of the bankruptcy of a company could be found within the high management fees that were being paid. These fees already existed at the moment the accused director started with her work activities. According to this court, the curator should have made plausible that the director could be accused of making such apparent mistakes that this resulted in the bankruptcy of the company. However, the Dutch Supreme Court disagreed with this judgement. From article 2:248 sub 3 Dutch Civil Code derives that the director should be the one to prove that the improper fulfilment of tasks cannot be contributed to him. Therefore, it was not the job of the curator to prove that the improper management was caused by the director.[8] The burden of proof in exculpation therefore definitely lies with the accused director.

3.2. External liability based on an act of tort

Besides the internal liability based on article 2:9 Dutch Civil Code and the external liability based on article 2:138 Dutch Civil Code and article 2:248 Dutch Civil Code, directors can also be held liable based on an act of tort. The articles mentioned above provide a specific basis for liability of directors. Article 6:162 Dutch Civil Code provides a general basis for liability of directors, namely the act of tort. External liability based on apparent improper management can only be invoked by the curator. Directors' liability based on an act of tort can also be invoked by an individual creditor. The Dutch Supreme Court distinguishes two types of directors' liability based on an act of tort.

3.2.1. Beklamel standard

First of all, liability based on an act of tort can be accepted on the basis of the so-called Beklamel standard. In this case, the director has entered into an agreement on behalf of the company, while he knew or reasonably should have understood that the company could not

[8] ECLI:NL:HR:2015:522 (Glascentrale Beheer B.V.).

comply with the obligations deriving from this agreement. The director therefore was aware of the fact that the company did not have the resources to comply with the agreement.[9] This entails that an act or tort can get accepted.

3.2.2. Frustration of resources

The second situation entails that directors' liability can get accepted when a director caused the fact that the company is not paying the creditors and does not have the sufficient assets to do so. Shortly, this is called frustration of resources. Because of actions of the director, the company is unable to comply with her payment obligations. The actions or negligence of the director is so careless, that a severe accusation can be made against him.[10] In this case, the burden of proof lies with the creditor; he has to prove that the director knew or reasonably should have understood that his action would result in the company not being able to comply with her obligations. Because of this heavy burden of proof, an appeal on this norm will not easily succeed.

4. Liability of the legal entity director

In the Netherlands, a natural person can be director of a legal entity but a legal entity itself can also be a director. To make things easier, the natural person who is a director will be called the natural director and the legal entity who is a director will be called the entity director in this chapter. The fact that a legal entity can be a director, does not entail that directors' liability can simply be avoided by appointing an entity director. This derives from article 2:11 Dutch Civil Code. A distinction can be made between entity directors and natural directors. When an entity director is held liable, this liability also lies with the person who is the natural director of this entity director. Based on article 2:11 Dutch Civil Code, the existence of liability of the entity director is a condition for liability of the natural director. Only when an entity director can be held liable, this liability will also apply to the natural directors of the entity director.

[9] ECLI:NL:HR:1989:AB9521 (Beklamel).
[10] ECLI:NL:HR:2006:AZ0758 (Ontvanger/Roelofsen).

4.1. The scope of article 2:11 Dutch Civil Code

Article 2:11 Dutch Civil Code definitely applies to situations in which directors' liability is assumed based on article 2:9 Dutch Civil Code, article 2:138 Dutch Civil Code and article 2:248 Dutch Civil Code. As mentioned before, these articles provide specific grounds for directors' liability. Directors' liability based on article 6:162 Dutch Civil Code provides a general basis for liability. Questions arose whether or not article 2:11 Dutch Civil Code also applies to directors' liability based on an act of tort.

In a recent judgement, the Dutch Supreme Court has decided that this is indeed the case. Article 2:11 Dutch Civil Code aims to prevent natural persons from hiding behind entity directors in order to avoid liability. This entails that article 2:11 Dutch Civil Code is applicable in all cases where a director can be held liable based on the law. This includes directors' liability based on an act of tort. In such cases, the condition that a severe accusation can be made against the natural director of an entity director does not apply. Liability of the entity director provides a sufficient basis for liability of the natural director. However, liability can be diverted when the natural director of an entity director states, and proves, that no severe accusation can be made against him with regard to the actions that form the basis for liability of the entity director.[11] As a matter of fact, the natural director can exculpate himself from liability. The judgment of the Dutch Supreme Court therefore displays that directors' liability of natural directors of entity directors can get accepted for all forms of directors' liability deriving from the law.

5. Discharge of the directors' board

Directors' liability can be averted by granting discharge to the directors' board. Discharge means that the policy of the directors' board, as conducted until the moment of discharge, is approved by the legal entity. Discharge is therefore a waiver of liability for directors. Discharge is not a term that can be found in the law, but it is often included in the articles of incorporation of a legal entity. Within companies, discharge is granted by the general meeting

[11] ECLI:NL:HR:2017:275.

of shareholders. Within associations, discharge is granted by the general meeting of members. In doing so, an internal waiver of liability is granted. Discharge therefore only applies to internal liability of directors. Third parties are still able to invoke liability of directors based on the legal grounds mentioned before. This also derives from article 2:138 sub 6 Dutch Civil Code and article 2:248 sub 6 Dutch Civil Code, which state that a possible discharge granted to the directors' board, does not obstruct the possibility of filing a claim.

5.1. Discharge does not offer guarantees

Discharge only applies to facts and circumstances that were known to the shareholders at the time the discharge was granted.[12] This includes matters that derive from the annual accounts and matters that are explicitly communicated to the shareholders. Liability for unknown facts and circumstances will still be present. When unknown facts surface after the discharge is granted, the discharge does not apply to these facts. Furthermore, discharge has to be communicated as a separate item during the general meeting and must be granted explicitly. This is based on article 2:49 sub 3 Dutch Civil Code, article 2:101 sub 3 Dutch Civil Code and article 2:211 sub 3 Dutch Civil Code. Discharge is therefore not a hundred percent save and does not offer guarantees; discharge does not avert external liability of directors and is only granted for facts and circumstances that were known to the organ that granted the discharge.

6. Conclusion

Entrepreneurship can be a challenging and fun activity, but unfortunately it does come with risks. A lot of entrepreneurs believe that they can exclude liability by founding a legal entity. These entrepreneurs will be in for a disappointment; under certain circumstances, liability of directors can apply. Directors can be held liable internally, by the legal entity itself, or externally, by a third party. This can have extensive consequences; a director can be held personally liable for all debts of the legal entity.

[12] ECLI:NL:HR:1997:ZC2243 (Staleman/Van de Ven); ECLI:NL:HR:2010:BM2332.

Conducting improper management is an important standard to decide whether or not liability of directors will be accepted. To accept improper management, a severe accusation must be made against the director. However, there are possibilities in order to avert directors' liability. This is the case when discharge is granted or when directors can exculpate. Yet, judges will assess these appeals strictly and the burden of proof lies with the director. Furthermore, it is not possible to avoid liability by appointing a legal entity as director. While entrepreneurship can be an enjoyable and lucrative occupation, the risks that come with it must not be underestimated. When directors' liability applies, this greatly impacts the personal life of the director concerned. It would be wise for directors to avoid directors' liability by complying with all legal stipulations and by managing the legal entity in an open and deliberate manner.

Contact

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