Chapter 5

"Wrongful Trading" in England and Hungary: A Comparative Study

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1 Introduction

At the time of writing, it is still unknown how, if at all, the EU Commission's legislative proposal due to be published in the framework if the "insolvency initiative"[1] in autumn 2016 addresses the harmonisation of the laws of Member States on some aspects of directors' liability. Given the long history of harmonisation attempts in this area, raising the idea of harmonisation again would not really be surprising.

In this paper, it is not intended to argue for or against a potential European legislation on the personal liability of directors. Its purposes are more limited. It aims to present a specific example of legal transfer[2] that took place in 2006 when Hungary imported the English concept of the liability for "wrongful trading".[3] The result of this legal transplant, it is believed, may be instructive for future incentives for harmonisation in the field of directors' liability.

In the second part of this paper, the initiatives of harmonisation of the directors' liability in the history of the European Communities is summarised. In the third part, the function of wrongful trading concept is shortly discussed. In the fourth part, a comparative analysis of the main features of the liability for wrongful trading both in England and Hungary is presented. Subsequently, the diverging

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1 European Commission, Insolvency Proceedings, available at http://ec.europa.eu/justice/civil/commercial/insolvency/index_en.htm (last viewed 25 April 2017). In the meantime, the Commission published its Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures, available at http://ec.europa.eu/information_society/newsroom/image/document/2016-48/proposal_40046.pdf (last viewed 8 May 2017). Article 18 of the draft Directive limits itself to determining some duties of the directors in the vicinity of insolvency.

2 *"Legal transfer"* or *"legal transplant"* means unilateral adoption of legal norms from other jurisdictions. See N. Garoupa and A. Ogus, "A Strategic Interpretation of Legal Transplants", (2006) 35 Journal of Legal Studies, p. 341.

3 On the legal transfer of the English provisions on wrongful trading see T. Cseh, "Új hitelezővédelmi jogintézmény a magyar társasági törvényben (wrongful trading) [New Legal Institution of Creditor's Protection in the Hungarian Companies Act (Wrongful Trading)]", (2006) 14 Gazdaság és Jog, pp. 9 ff.

tendencies in case law is discussed. In the sixth part, an indication of some possible reasons why wrongful trading provisions play a more prominent (and different) role in Hungary than they do in England is given. As a conclusion, it will be attempted to answer the following questions: (i) Do the Hungarian provisions on liability for wrongful trading qualify as a "legal transplant"? (ii) Has the adoption of the English concept of wrongful trading resulted in "harmonised" or "unified" rules[4] on directors' liability for wrongful trading in England and Hungary?

2 Harmonisation Initiatives

The concept of uniform rules in the field of director's liability throughout the Member States emerged early in the history of the European Communities. The 1970 Preliminary Draft Convention[5] envisaged a number of territories where the contracting states would have been required to harmonize their substantive laws. The personal liability of directors was one of these areas. However, the idea did not survive the Preliminary Draft Convention: no similar provision can be found in the latter versions of what eventually became the 2000 Insolvency Regulation.[6] The thought emerged again in 2003. The Commission, reflecting to the initiative of the "High Level Group"[7] proposed[8] introducing a wrongful trading rule similar to that found in England. However, on the basis of the responses that the Commission received,[9] the idea was abandoned.[10] In 2010 the idea of harmonisation turned up again. This time, INSOL Europe, commissioned by the European Parliament,

4 *"Legal harmonization"* is a cooperative approach of approximation of laws through setting of objectives and targets and let each nation amend their internal law to fulfil the chosen objectives. *"Legal unification"* is an extreme version of harmonization replacing national rules and adopting a unified set of rules chosen at the interstate level. See E. Carbonara and F. Parisi, "The Paradox of Legal Harmonization", (2007) 132 Public Choice, p. 368; N. Garoupa and A. Ogus, *ibid*., p. 343. The dichotomy of harmonisation and unification is mirrored at the level of the legislative acts of the EU. „With the use of »directives« member states of the EU harmonize their national legal systems by setting common goals and standards. With »regulations« EU countries instead agree to replace their respective national laws with a common rule which becomes directly applicable in the national systems of all member states."; see E. Carbonara and F. Parisi, *ibid*., p. 368.

5 Preliminary Draft of a Convention on Bankruptcy, Winding-Up, Arrangements, Compositions and Similar Proceedings. Translation of Commission Document 3.327/1/XIV/70, 4 June 1973. [EU Commission - Working Document]' (1973), Annex 1 Article 1.

6 Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings [2000] OJ L160/1.

7 J. Winter et. al., "Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe" (2002), available from http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf (last viewed 27 July 2016).

8 Communication from the Commission to the Council and the European Parliament Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward COM (2003) 284 Final.

9 Synthesis of the Responses to the Communication of the Commission to the Council and the European Parliament "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward" – COM (2003) 284 Final of 21 May 2003.

10 P. J. Wright, "Challenges to the Harmonization of Business Law: Domestic and Cross-Border Insolvency" (2015) SSRN Electronic Journal, available at: http://papers.ssrn.com/abstract=2658230 (last viewed 1 August 2016), pp. 15 ff.

conducted a report[11] identifying some areas of insolvency law where harmonisation at EU level seemed to be worthwhile and achievable. The report of INSOL Europe concluded that, among other things, directors' liability could have been subject of harmonisation. At a later stage of the legislative process, this aspect of the initiative seemed to have evaporated.[12] Recently, however, following a communication[13] on a new European approach to business failure and insolvency, the Commission adopted a recommendation[14] in March 2014. This 2014 Recommendation aims at establishing minimum standards for: (i) preventive restructuring procedures enabling debtors in financial difficulty to restructure at an early stage with the objective of averting insolvency, and (ii) debt discharge, within prescribed periods, for honest bankrupt entrepreneurs as one of the steps necessary to provide them with a second chance. Neither in these texts nor in the evaluation[15] of the 2014 Recommendation by the Directorate-General Justice & Consumers of the European Commission is any direct referral to the intended harmonization of the rules on the personal liability of the directors. Notwithstanding, the idea seems to keep entertaining the European legislator.[16] By the time of the publication of this paper it will be known to what extent and how, if at all, the legislative proposals of the Commission addresses the issue of directors' liability.

3 The Function of the Provisions on Wrongful Trading

The principle underlying the wrongful trading concept is the protection of creditors in the period of time when the debtor company still operates, but is in a state of imminent insolvency. Diverging incentives can be detected in this period of time.[17] The director, acting in the interest of the company, may want to trade the company out from the difficult situation, but to do so he needs time, and possibly more credit and new obligations. The unsecured creditors may be concerned that the assets of the debtor, which are the only coverage for their claims, are melting away and that

11 INSOL Europe, *Harmonisation of Insolvency Law at EU Level*, (2010) https://www.insol-europe.org/technical-content/european-insolvency-regulation (last viewed 1 September 2016).

12 See Report with Recommendations to the Commission on Insolvency Proceedings in the Context of EU Company Law (2011/2006(INI) (2011); European Parliament Resolution of 15 November 2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law, P7_TA (2011) 0484 2011.

13 A New European Approach to Business Failure and Insolvency COM(2012) 742 Final.

14 Commission Recommendation of 12.3.2014 on a New Approach to Business Failure and Insolvency C(2014) 1500 final.

15 Evaluation of the Implementation of the Commission Recommendation of 12.3.2015 on a New Approach to Business Failure and Insolvency (2015), available at http://ec.europa.eu/justice/civil/files/insolvency/02_evaluation_insolvency_recommendation_en.pdf (last viewed 8 May 2017).

16 See e. g. the reports of the Group of experts on restructuring and insolvency law at http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3362 (last viewed 8 May 2017).

17 On the incentive structures see G. Spindler, "Trading in the Vicinity of Insolvency", (2006) 7(1) EBOR, pp. 340. ff.

they will end up in a position worse than it would have been if formal insolvency proceedings had started earlier in time. As Professor Keay put it,

> "[i]f the risk-taking [by the director] pays off, then the shareholders will see their wealth maximised, but if it does not, then they have lost nothing more; it is the creditors who will bear the cost."[18]

Beyond this, the interest of the employees and the wider public is, generally, to save the company or at least the business as going concern. The secured creditors normally want their security interests to retain their value, etc.

Directors are among the key players in the situation when the company is on the verge of insolvency. They may just throw in the towel, stop trading and file an application for winding up (insolvent liquidation). They may file for formal insolvency proceedings designed for reorganisation of the company or rescuing the business. Alternatively, they may continue operations and try to trade the company out of its difficulties. Should the latter option be chosen, there is little to protect the interests of the creditors of the struggling company.

Two main strategies appear to exist in Europe when dealing with the protection of creditors' interests in the vicinity of insolvency: the "duty to file" strategy and the "wrongful trading" strategy. The reports drafted by the London School of Economics[19] and more recently by the team of University of Leeds[20] give a detailed account on these strategies.

The duty to file strategy is more common in Europe. The majority of the member states[21] of the EU expect the directors to file for insolvency within a certain period of time after the insolvency (on cash-flow or balance sheet basis) occurs. Should the director fail to comply with that rules then he may be liable for the damage caused to the creditors while delaying the insolvency. Apparently, this concept puts the emphasis on the formal insolvency proceedings and leaves less room for either a potential "trade out" by the debtor company or informal rescue strategies.

18 A. Keay, "Wrongful Trading and the Liability of Company Directors: A Theoretical Perspective", (2005) 25 Legal Studies 434.

19 C. Gerner-Beuerle *et. al*., "Study on Directors' Duties and Liability", (the "London Report"), (2013, London), pp. xiv, 208 ff.

20 Gerard McCormack *et. al*., "Study on a New Approach to Business Failure and Insolvency – Comparative Legal Analysis of the Member States' Relevant Provisions and Practices" (the "Leeds Report"), (2016), 48 ff.

21 E.g. Germany, France, Austria, Belgium, Poland, Spain, Portugal etc. For more details, see the London and Leeds Reports, above notes 19 and 20.

A minority group of the member states[22] incentivise directors to respect the interest of the creditors by imposing special – and personal – liability for diminution of assets in the period of the approaching insolvency. Following the English example, this can be called the "wrongful trading" strategy. As we are going to see below, the basis of the liability in the English law is that the director continues operating the company whilst he knows or should know that there is no reasonable prospect of avoiding an insolvent winding-up. The wrongful trading strategy indicates a more flexible approach where there is much more room to try to trade out of the difficulties by continuing operations or attempting to rescue the company through informal agreements with (some of) the creditors. However, because the apparent victims of failed behind-the-door rescue attempts are creditors, their interests are protected by special rules making directors liable for losses suffered by the debtor in the vicinity of insolvency.

4 Wrongful Trading in England and Hungary

4.1 The Legal Transplant to Hungary

In England the liability for wrongful trading was introduced[23] in the 1986 Insolvency Act (IA) *in addition* to other existing civil remedies, first of all the provisions on fraudulent trading and misfeasance.[24] By contrast, virtually no civil law protection was available in Hungary for creditors *vis-à-vis* the directors of the insolvent company prior to 2006.[25] As long as the company was not formally insolvent (no insolvency proceedings were opened) in most cases directors were free to operate the debtor company without any relevant restrictions. Even if the management activity of the director resulted in the increase of the net deficiency of

22 E.g. the U.K., Ireland, Malta, Cyprus, Hungary. For more details, the London and Leeds Reports, above notes 19 and 20. Of course, the two strategies may be combined: e.g. under certain circumstances Hungarian companies are required to file for insolvency, see § 3:189 and § 3:270, Act V of 2013 on the Civil Code (the "Civil Code").

23 On the background, aims, rationale of the liability for wrongful trading in comparative context see A. Keay, *Company Directors' Responsibilities to Creditors* (2007, Routledge-Cavendish, London), pp. 73-80.

24 Fraudulent trading is a cause of action which arises if, in the course of winding-up a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or has been carried on for any fraudulent purpose, see section 213, IA. *Misfeasance* is a cause of action which arises if, in the course of winding-up a company, it appears that a person has misapplied or retained, or become accountable for, any money or other property of the company, or has been guilty of any wrongdoing or breached their duties of trust (for example, duty to hold something in trust) in relation to the company, see section 212, IA. On the number of the cases in England and Wales classified according to the different types of actions see P. Walton, "Insolvency Litigation and the Jackson Reforms – An Update" (the "Walton Report") (2016), available at https://www.r3.org.uk/media/documents/policy/research_reports/bus_distress_index/Insolvency_Litigation_and_the_Jackson_Reforms_-_An_Update_April_2016_FINAL.pdf (last viewed 18 April 2017), pp. 18-19.

25 See 2006. évi VI. törvény indokolása a csődeljárásról, a felszámolási eljárásról és a végelszámolásról szóló 1991. évi XLIX. törvény módosításáról [Explanatory note on the Act VI of 2006 amending of the Hungarian Insolvency Act].

the debtor, that did not typically provoked the personal liability of the executives *vis-à-vis* creditors.[26]

What is equally relevant is that even before the import of the wrongful trading provisions from England, no efficient "duty to file" rule existed in Hungary. This means that Hungary applied none of the main strategies designed for protection of the creditor's interests in the vicinity of the insolvency. In other words, there were no efficient rules forcing the directors or shareholders to start formal insolvency proceedings within a certain period of time after the company became insolvent, virtually nothing prevented directors from continuing to operate long-insolvent companies and accumulate further losses to the creditors of the dying company.

Quite often, legal transplants occur because a legal institution another nation has is deemed superior.[27] If that is true, the transfer of the liability for wrongful trading from the English law to the Hungarian legal system was more than justified. The wrongful trading concept had at least two features which were new and superior as compared to the Hungarian law. First, the newly adopted provisions established the legal basis of the liability of corporate directors directly vis-à-vis the creditors of the debtor company. Second, the new concept created an obligation on the side of the company directors to take into consideration the interests of the creditors in the period of *imminent* insolvency, i.e. *prior* to the factual insolvency.[28]

4.2 The Key Ingredients of Wrongful Trading in English and Hungarian Law

The basic elements of the liability for wrongful trading pursuant to the IA[29] and the Hungarian Insolvency Act (HIA)[30] are, somewhat generalised, as follows:

26 In fact, a kind of statutory derivative action for compensation and some judge-made remedies were available; see below under heading *6 Possible reasons for the diverging case law*.

27 M. Graziadei, "Comparative law as the study of transplants and receptions", Chapter 13 in M. Reimann and R. Zimmermann (eds.), *The Oxford Handbook of Comparative Law* (2006, OUP, Oxford), pp. 457 ff.

28 In theory at least, wrongful trading rules impose duties on directors already *prior* to the onset of material insolvency. However, as Bachner demonstrated, this is not necessarily the case. In fact, English courts tend to establish the starting point of the critical period (thus the beginning of the special duties) at a later stage of the agony, when the company is already (cash-flow or balance sheet) insolvent. See Th. Bachner, "Wrongful Trading - a New European Model for Creditor Protection ?", (2004) 5(2) European Business Organization Law Review, pp. 296 ff. Similarly, A. Campbell, "Wrongful Trading and Company Rescue Andrew", (1994) 25 Cambrian L. Rev., p. 74.

29 Section 214, IA.

30 § 33/A, Act XLIX of 1991 on Reorganisation Proceedings and Liquidation Proceedings. Note that, to some extent, "culpable trading" as a sub-category of the criminal offence "fraudulent insolvency", § 404(1), Act C of 2012 on the Hungarian Criminal Code, can be interpreted as a criminal law counterpart of the wrongful trading; for an analysis of the interplay between the two remedies see M. Tihanyi, "A vezetői felelősséggel kapcsolatos megállapítási per (wrongful trading) lehetséges hatásai a vétkes gazdálkodással elkövetett csődbűncselekmény miatt indult büntetőeljárásokra [The possible effects of the declaratory action regarding the liability of the directors (wrongful trading) on the criminal proceedings due to fraudulent insolvency committed through culpable trading]", working paper, http://www.mabie.hu/node/2491 last viewed 17 October 2016.

- Formal insolvency proceedings[31] have been opened against the debtor company. If the debtor is able to avoid opening formal insolvency proceedings the director will not be liable for wrongful trading.
- The director knew or should have concluded before the commencement of the formal insolvency proceedings that the company would be unable to avoid going into insolvent liquidation or administration (in England) or that the company is in the state of imminent insolvency (in Hungary).
- The person affected was, in a wide sense, a director of the company during the critical period.
- The director fails to prove that he took every step he ought to have taken to minimise the loss to creditors.
- The continued operation caused loss to the creditors.

Under the subsequent headings a comparative analysis of these ingredients will be provided.

4.3 Similarities between English and Hungarian Wrongful Trading Provisions

4.3.1 The Debtor Goes into Insolvent Liquidation

Both in England and Hungary, precondition to the liability for wrongful trading is that insolvent liquidation proceedings[32] have been opened against the debtor company. This form of liability is *per definitionem* retrospective. The liability is not an end in itself: should the continued trading or rescue turn out to be successful and, as a consequence, the company regains solvency, there is no point to penalise the director for the – eventually successful – decision to continue business activity even in a seemingly hopeless situation.

4.3.2 The Addressees of the Norm are Directors in a Wide Sense

Section 214 of the IA requires the persons targeted to be directors. First of all, this category includes *de jure* directors, i.e. those who occupy the position of director, by whatever name called.[33] Also *de facto* directors are included.[34] A *de facto* director is a person who assumes to act as a director. He is held out as a director

31 In England: winding up or insolvent administration where the insolvency is to be determined on the basis of the balance sheet test, see Section 214, IA; Section 246ZB, IA; in Hungary: *felszámolási eljárás* (liquidation proceedings), see § 33/A, HIA.

32 *Ibid.*

33 Section 251, IA.

34 See Hydrodan (Corby) Ltd (In Liquidation), Re [1994] BCC 161.

by the company, and claims and purports to be a director, although never actually or validly appointed as such.[35] Finally, the statute itself provides that the category of director includes also shadow directors, too.[36] Shadow director, in relation to a company, means a person in accordance with whose directions or instructions the directors of the company are accustomed to act.[37] Millett J. characterised a shadow director as someone who:

> "[…] does not claim or purport to act as a director. On the contrary, he claims not to be a director. He lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself."[38]

In Hungary, the concept of director refers first of all to *de jure* directors.[39] Beyond that, the statute provides that any person who has in fact exercised dominant influence on the decision-making mechanisms of the debtor company shall also be considered an executive, i.e. subject to liability.[40] This category is generally mentioned as "shadow directors" in judgements and the literature but the definition appears to cover both shadow and *de facto* directors. By contrast to the English statute, the HIA limits the application of the wrongful trading provisions to those directors who have been in this position in the period of three years prior to the opening of the insolvency proceedings.[41]

4.3.3 Exculpation of Directors

The defence to wrongful trading actions is addressed by both the IA and the HIA in a rather similar way. Should the director as defendant in the wrongful trading litigation be able to prove that he took every step with a view to minimising the potential loss to creditors he ought to have taken (in Hungary: that is to be expected from persons in such position), then no liability is incurred.[42] This is a defence to the wrongful trading action thus the burden of proof, principally, lies on the director.

35 R. Goode, Principles of Corporate Insolvency Law (2011, Sweet & Maxwell, London), pp. 641-643.

36 Section 214(7), IA.

37 Section 251, IA.

38 *Hydrodan (Corby) Ltd (In Liquidation), Re* [1994] BCC 161, at 163.

39 § 3(1)(d), HIA.

40 § 33/A(1), HIA.

41 *Ibid*.

42 Section 214(3), IA; § 33/A(3), HIA. The HIA adds that the it is expected from the director to prompt the supreme body of the debtor company to take action.

In Hungary, however, there appears to be some ambiguity regarding the burden of proof. On the one hand, the wording of the statute suggests that the claimant is expected to prove that the director, when continuing trading, disregarded the interests of the creditors.[43] On the other hand, the HIA provides that the director as defendant who is able to prove to have taken all reasonable measures expected from persons in such positions, upon the occurrence of the imminent insolvency so as to prevent and mitigate the losses of creditors, and to prompt the supreme body of the debtor's economic operator to take action, shall not be held responsible. Thus, it is not completely clear on the basis of the wording of the statute, which party is expected to establish that the director reasonably tried to protect the interests of the creditors. The position of the Curia (Highest Court of Hungary) is not completely straightforward, either. In one judgement, the judicial body ruled that the occurrence and the date of the imminent insolvency, the fact and the extent of the increase of the net deficiency and the causal relation between the behaviour of the director and the increase of the net deficiency were to be proved by the claimant. On the other hand, the defendant director needs to prove that he has taken all reasonable measures expected from persons in such positions to prevent and mitigate the losses of creditors.[44] However, another decision suggests that the claimant is required to establish also that the director acted in a way contrary to the interests of the creditors during the critical period.[45]

4.3.4 Losses during Continued Trading

Section 214 of the IA does not expressly require any loss suffered by the creditors, but it is well-established in case law that the continued trading should make the company's position worse, so that it has less money available to pay creditors, rather than to leaving the company's position at the same level.[46] Importantly,

43 Before 15 March 2014 the statute expected to establish that the director failed to act on the basis of the priority of the creditors' interests. Since, the statute has expected directors to take into consideration the interests of the creditors, thus there is no clear priority order. However, the changing in the wording of the statute may have no effect on the case law, see A. Csőke, "A vezető tisztségviselő felelőssége fizetésképtelenség és felszámolás esetén [Liability of executives in the context of insolvency and liquidation]", in Z. Csehi and M. Szabó (eds), A vezető tisztségviselő felelőssége [Liability of the executives] (2015, Wolters Kluwer, Budapest) p. 142.

44 Legfelsőbb Bíróság Gfv.X.30.047/2011/3. cf. A Kúria Polgári Kollégiuma Joggyakorlat-elemző Csoport [Civil Department of the Curia, Expert Group Analysing the Case Law], "A vezető tisztségviselők hitelezőkkel szembeni felelőssége« tárgykörben felállított joggyakorlat-elemző csoport összefoglaló véleménye (A Kúria Polgári Kollégiuma által 2017. február 6-án elfogadott összefoglaló vélemény) [Summary Opinion of the Expert Group on the Subject of »the Liability of the Executives vis-à-vis the Creditors" (Summary Opinion approved by the Civil Department of the Curia on 6 February 2017] [2016.El.II.JGY.G.2.] (the "Summary Opinion"), available at http://lb.hu/sites/default/files/joggyak/osszefoglalo_velemeny_6.pdf (last viewed 12 February 2017); the Summary Opinion appears to share this view, pp. 25-27, 31-32.

45 Kúria Gfv.VII.30.303/2013/6.

46 *Re Continental Assurance plc* [2001] BPIR 733 at paragraph 9 of Annex B; *Ralls Builders* [2016] EWHC 243 (Ch) at paragraph 241.

English provisions on wrongful trading seem to focus merely on the general body of the creditors: form the point of view of the wrongful trading prohibition, it is not relevant if some creditors are paid fully during the period of continued trading while others end up receiving nothing due to payments made to other creditors.[47] What matters is the overall debt position of the company: as long as the overall position does not worsen during the critical period, no loss of assets occurs for the purposes of wrongful trading.

The HIA expressly provides[48] that some kind of loss is required to activate wrongful trading liability: either the debtor's assets have diminished, or the director obstructed full satisfaction for the creditors' claims, or has neglected to carry out the cleaning up of environmental damages. However, in order to trigger this type of liability the director must disregard the creditors' interests in consequence of which the losses occur. In other words, even if the asset pool diminishes during the critical period that does not automatically result in the liability of the director. Some additional element, typically a fraudulent or grossly negligent act of the director, is required.[49]

Note that case law appears to be rather divided as to whether payments to selected creditors diminishing the asset pool of the company and decreasing the shares to be paid to the remaining creditors is contrary to the prohibition of wrongful trading. This question will be analysed below.[50]

4.3.5 The Quantitative Limit of the Compensation

The IA simply provides that the court may declare that the director is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.[51] These are very wide words of discretion and, as Knox J. stated, it would be undesirable to seek to spell out limits on that discretion.[52] Still, the principle is that the contribution to the assets in which the company's creditors will share in the liquidation should reflect (and compensate for) the loss which has been caused to those creditors by the carrying on of the business when the insolvent liquidation could not be avoided.[53]

47 *Re Continental Assurance plc* [2001] BPIR 733 at paragraph 8 of Annex B; *Ralls Builders* [2016] EWHC 243 (Ch) at paragraphs 239-240.

48 § 33/A(1), HIA.

49 BDT2016 3499 (Debreceni Ítélőtábla Gf. IV. 30 369/2015/6).

50 See below under the heading *4.5.2 Which creditors can be lawfully paid off during the critical period?*

51 Section 214(1), IA.

52 *Produce Marketing Consortium (In Liquidation) Ltd, Re (No2)* [1989] 5 BCC 569, at 597-598.

53 *Morphitis v Bernasconi* [2003] EWCA Civ 289, at paragraph 55 (in relation to fraudulent trading).

In Hungary, the established principle is that the upper limit of the liability for wrongful trading is the amount by which the assets of the debtor have diminished during the critical period, as long as this is attributable to the director.[54]

4.4 The Differences

4.4.1 What should the Director Foresee?

Pursuant to the English statute, what the director knew or ought to have concluded is that there was no reasonable prospect of avoiding insolvent liquidation or insolvent administration.[55] Once the director first gains this "deemed knowledge"[56], the critical period begins. For the purposes of this provision, insolvent liquidation or administration means that the assets are insufficient for the payment of debts and other liabilities and the expenses of the winding up or those of administration (balance-sheet test).[57] The statute provides for both objective and subjective tests regarding the directors. The focus of the objective test is what should be known or concluded by a reasonably diligent person having the general knowledge, skill, and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company. Then, the subjective test focuses on the what should be known or concluded by this reasonably diligent person with the general knowledge, skill, and experience that the director in question (i.e. the defendant of the wrongful trading litigation) has.

It is crucial to emphasise that the focus is not on insolvent trading but on the question of whether there is a reasonable prospect of avoiding insolvent liquidation. Insolvent trading in itself does not give rise to wrongful trading.[58] As Snowden J. put it,

> "[i]t is important to note that the fact that a company is insolvent (on a balance sheet or cash-flow basis) and carries on trading does not mean that a director – even one with knowledge of that fact — will be liable for wrongful trading if the company fails to survive. Many companies show a balance-sheet deficit from time to time, but nevertheless have every real prospect of trading out of that position or otherwise recovering from the deficiency and thereby avoiding an insolvent liquidation […]. Likewise, trading companies often suffer

54 Legfelsőbb Bíróság Gfv.X.30.047/2011/3.; Debreceni Ítélőtábla Gf.III.30.387/2012/5.; Summary Opinion, above note 44, p. 23.

55 Section 214(2)(b), IA and Section 246ZB(2)(b), IA.

56 Goode, above note 35, p. 670.

57 Section 214(6), IA and Section 246ZB(6), IA.

58 See *Brooks v Armstrong* [2015] EWHC 2289 (Ch).

> cashflow difficulties and fail to pay their creditors on time, but are able to overcome that cash-flow insolvency by (for example) selling an asset or raising external finance on the security of their assets."[59]

What triggers the liability is not the factual insolvency of the debtor but rather "the type of situation […] where the director has been held to have had no rational basis for believing that the event that they hoped would save the company would come about."[60] To sum up, the critical period does not begin just because the debtors is insolvent: as long as there is reasonable prospect to trade the company out of the difficulties, the threat of wrongful trading does not emerge, even if the director knows about the insolvency and even if the continued trading in the period of insolvency results in loss to the creditors. English courts tend not to place undue emphasis on hindsight and avoid the danger of assuming that what has in fact happened was always bound to happen and was apparent.[61] As Lewison J expressed in so graphic terms,

> "[o]f course, it is easy with hindsight to conclude that mistakes were made. An insolvent liquidation will almost always result from one or more mistakes. But picking over the bones of a dead company in a courtroom is not always fair to those who struggled to keep going in the reasonable (but ultimately misplaced) hope that things would get better."[62]

In Hungary, the critical period begins with the occurrence of imminent insolvency. Pursuant to the legal definition, imminent insolvency starts when the directors were or should have been reasonably able to foresee that the debtor company would not be able to satisfy its liabilities when due[63] (cash-flow test). In other words, as long as the director knows or should foresee that the debtor is cash-flow insolvent he is exposed to the liability for wrongful trading if further elements of the liability are present. The Curia found that

> "[r]egarding the occurrence of the imminent insolvency the relevant question is whether the debtor is able to settle its debts when due. If the debtor is unable to do so because it has neither liquid assets nor

59 *Ralls Builders* [2016] EWHC 243 (Ch) at paragraph 168.

60 *Ibid.* at paragraph 174.

61 *Sherborne Associates Ltd, Re* [1995] BCC 40 at 54; *Brian D Pierson (Contractors) Ltd, Re* [1999] BCC 26 at 50; *Hawkes Hill Publishing Co Ltd (In Liquidation), Re* [2007] BCC 937 at paragraph 47; *Ralls Builders* [2016] EWHC 243 (Ch) at paragraph 173.

62 *Hawkes Hill Publishing Co Ltd (In Liquidation), Re* [2007] BCC 937 at paragraph 47.

63 § 33/A(1), HIA. Further, see Summary Opinion, above note 44, pp. 20-21; A. Csőke, "A fizetésképtelenséggel fenyegető helyzet [The imminent insolvency]", (2016) (Annex No 2 to the Summary Opinion), pp. 66-70.

> credit to settle its debts and it is unable to agree with its creditors on a different kind of performance or adjustment of the due date then the imminent insolvency occurs even if the other assets of the debtor […] exceeds the amount of debts."[64]

When applying the rather rigid cash-flow test, it appears that the hope in realising some uncertain incomes in the future is insufficient to be shielded from imminent insolvency.[65] László Juhász, a Hungarian senior judge noted, regarding the rather rigid notion of imminent insolvency, that:

> "[h]owever difficult it is to say, it is a fact that a significant number of enterprises operating in Hungary need to face with the fact on a daily basis that they will not be able to pay off their debts when due if they are unable to collect their receivables. The executives should realise that in such situations they are acting in the state of imminent insolvency even if [the debtor] has significant assets […]."[66]

In several cases, Hungarian courts apply the current ratio test or even the quick ratio test to determine the cash-flow situation of the company.[67] The current ratio is a basic indicator calculated by dividing total current assets by total current liabilities; the quick ratio, by contrast, takes into account the most liquid current assets: it is calculated by adding cash and equivalents, marketable investments, and accounts receivables, and dividing that sum by current liabilities. Although the wording of the HIA ("were or should have been reasonably able to foresee") seems to suggest that, similar to the English provisions, both an objective and subjective test applies, the Curia ruled that

> "[t]he occurrence of the imminent insolvency is to be examined from the point of view of the knowledge of the director, i.e. of those circumstances he has been able to recognise."[68]

To sum up, the difference between the English and Hungarian approach is of paramount importance: While an English director is safe from wrongful trading liability as long as there is reasonable prospect to avoid insolvent liquidation, his

64 BH2014. 188. (Kúria Gfv. VII. 30.247/2013.); Kúria Gfv.VII.30.265/2015/4.

65 Fővárosi Ítélőtábla 15.Gf.40.043/2015/5/II.

66 L. Juhász, A Magyar fizetésképtelenségi jog kézikönyve [Textbook on the Hungarian insolvency law] (2014, Novotni Kiadó, Miskolc) [electronic edition] p. 484.

67 Fővárosi Ítélőtábla 12.Gf.40.469/2013/5.; Fővárosi Ítélőtábla 12.Gf.40.679/2015/5-II.; Fővárosi Ítélőtábla 12.Gf.40.013/2015/6-II. See also Csőke, above note 63, pp. 67-69. For an analysis of the methods of examination of the imminent insolvency see S. Fónagy, "A Fizetésképtelenséggel fenyegető helyzet megítélése [Assessment of the imminent insolvency", (2015) 23 Gazdaság és Jog, pp. 16 ff.

68 BH2014. 188. (Kúria Gfv. VII. 30.247/2013).

Hungarian counterpart is exposed to personal liability once and as long as the debtor company is cash-flow insolvent. Most probably this provision radically increases the number of the potential defendants in Hungary.[69]

4.4.2 Who initiates the wrongful trading litigation and benefits from it?

The IA reserves the power for liquidators and administrators to claim against directors for wrongful trading.[70] Should the court approve the claim the director is declared to be liable to make a contribution to the company's assets. The contribution serves the purpose of making a distribution to the unsecured creditors, and is therefore not available for a charge holder.[71]

In Hungary, the legislator followed a different path. For some reasons, the legislator designed the rules so that the court cannot oblige the director to contribute to the asset pool of the debtor company. Instead, a peculiar two-level litigation has been introduced. In the first phase, after the opening but before the closing of the insolvency proceedings, a declaratory action should be brought against the former director. This claim is available for both the liquidator and any creditors. The litigation is declaratory in nature. It is aimed at establishing the liability and the amount of the diminution of assets caused by the continuation of the business activity during the critical period of imminent insolvency.[72] No performance may be sought in this proceeding. Then, in a second step, after the closing of the insolvency proceedings, assuming that the assets of the debtor do not or only partly cover the creditors' claims (so in virtually all cases), the creditors, but not the liquidator anymore, may bring an action for performance.[73] In this second phase of the litigation the court, if approving the claim, orders the former director to compensate those creditors on *pro rata* basis who initiated this second litigation. The maximum of the compensation to be shared among those creditors amounts to the net deficiency accumulated during the critical period as established by the court in the first phase of the litigation. One of the inexplicable peculiarities of the rules is that the second litigation may be initiated by any creditors, i.e. also by those who did not even participate in the first litigation. The root of the problem is that – for an unknown reason – the statute does not require the defendant director to contribute

69 See below under the heading *6 Possible reasons for the diverging case law*.

70 Section 214(1), IA and 246ZB(1), IA.

71 *Re Oasis Merchandising Services Limited* [1998] Ch 170; *Ralls Builders* [2016] EWHC 243 (Ch) at paragraph 235.

72 1/2013. (II. 28.) Polgári jogegységi határozat. See A. Csőke, "A vezető tisztségviselő felelőssége [Liability of the executive]", in A. Csőke, E. Lettner and Cs. Juhász, Nagykommentár a csődeljárásról és a felszámolási eljárásról szóló 1991. évi XLIX. törvényhez [Comprehensive Commentary on the Insolvency Act] (2015, Wolters Kluwer, Budapest) [electronic edition], at § 33/A.

73 § 33/A(6), HIA. See also 1/2013. (II. 28.) Polgári jogegységi határozat [Civil uniformity decision].

to the assets of the debtor company.[74] Instead, the claimants are free to enforce their claims on a quasi-individual basis in the second stage of the litigation. This appears to be contradictory to the principle of collective insolvency proceedings. Note that the legislator has recently eased the strict separation of the two stages of litigation by enabling the claimants to request performance during the insolvency proceedings if, according to the interim financial statement, the debtor's assets are insufficient to cover the creditors' claims.[75]

4.4.3 Statutory Presumption

In Hungary, a statutory presumption assists the claimant in several cases.[76] The violation of the interests of the creditors is presumed if the director, failing to comply with the law, did not deposit and publish the debtor's annual accounts prior to the opening of liquidation proceedings and/or breached his obligation to cooperate with the liquidator by providing him with the relevant information and documentation. There are some questions regarding this provision. *First*, the rule apparently fails to determine the length of the period before the opening of the liquidation proceedings concerning which the failure to deposit and publish the annual accounts is taken into consideration. *Secondly* and more importantly, there is some uncertainty in the case law regarding the scope of the presumption. The position of the Curia is that, if the claimant proved the occurrence and beginning of the imminent insolvency and the increasing of the net deficiency in the critical period then, should the statutory presumption be applied, it is presumed that the director neglected the interests of the creditors and this is in causal relation with the losses to the creditors.[77] Others suggest that the scope of the presumption is much wider and extends to the occurrence of the imminent insolvency and the increase of the net deficiency during the critical period.[78]

The statutory presumption does not operate regarding shadow directors.[79]

4.4.4 Majority Shareholder as *ex lege* Guarantor

The concept of lifting the corporate veil, i.e. ignoring the separate legal personality of the company thereby imposing personal liability on shareholders, is recognised,

74 Csőke, above note 72, at § 33/A.

75 § 33/A(7), HIA.

76 § 33/A(3), HIA. cf Summary Opinion, above note 44, pp 22-25; P. Lakatos, "A vezető tisztségviselő felelőssége vélelmének fennállásával kapcsolatos kérdések [Questions regarding the Statutory Presumption of the Liability of the Executives]" (undated) (Annex No 5 to the Summary Opinion), pp. 80-84.

77 Kúria Gfv.VII.30.024/2015/4; Kúria Gfv.VII.30.059/2015/5.

78 M. Dzsula, "A vezető tisztségviselő felelősségével kapcsolatos jogalkalmazási problémák II. [Issues regarding application of law relating to the liability of executives II.]" (2013) 23(7) Céghírnök, p. 9.

79 ÍH 2012.91. (Fővárosi Ítélőtábla 14.Gf.40.493/2011/4)

although it plays a minor role, in England.[80] In Hungary, this concept enjoys a wider recognition and shareholders need to consider a number of statutory provisions making them personally liable vis-à-vis the creditors of the insolvent company.[81] What is common in these actions is that they focus on the shareholders of the debtor company.

By contrast, the liability for wrongful trading is generally reserved for directors of the debtor company, even if the term "director" is to be construed in a wide sense: beyond *de jure* directors, it includes *de facto* and shadow directors. Actually, the term "shadow director" is so widely drafted both in the English and the Hungarian statutes that it may cover also controlling shareholders – assuming, of course, that they interfere in the management of the company in a way that verifies this qualification.[82]

One of the peculiar characteristic of the Hungarian legislation is that, in an indirect but unambiguous way, it puts the majority shareholder of the debtor company to the position of a "statutory surety" (guarantor) of the director regarding the liability for wrongful trading even if that majority shareholder does not fall within the category of shadow director. The essence of the provision[83] is that the claimants of the declaratory action, i.e. the first litigation,[84] may request the court to order the director as defendant to provide financial security for the case if – typically later, in the second litigation (action for performance)[85] – the court finds the director liable for wrongful trading and obliges him to pay compensation to the creditors on pro rata basis. Should the judgement ordering the former director to pay compensation to the creditors turn out to be unenforceable, e.g. because the director is impecunious, then the creditors as claimants will be able to recover their claims approved by the court from the financial security. Up to this point the system is consistent, if not really efficient. However, the statute goes further. The majority shareholder of the debtor company shall be deemed, by force of law, as a guarantor regarding the financial security if the latter cannot be recovered from the director. Practically, by this provision the legislator expanded the liability for wrongful trading, originally targeting the managers of the company, to the majority shareholders. Thereby, beyond providing an apparent benefit to the creditors, the

80 P. L. Davies, S. Worthington and E. Micheler, Principles of Modern Company Law (2016, Sweet & Maxwell, London) pp. 191-206.

81 See § 3:2(2) and § 3:324. § (3, Civil Code; § 63(2) and § 63/, HIA; § 118/A, Act V of 2006 on Public Company Information, Company Registration and Solvent Winding-up Proceedings.

82 Regarding the IA see Goode, above note 35, p. 668.

83 § 33/A(2), HIA.

84 See above under the heading *4.4.2 Who initiates the wrongful trading litigation and benefits from it?*

85 *Ibid*.

legislator virtually eliminated the, otherwise very real, conflict of interests between directors and the majority shareholders arising from the threat of liability for wrongful trading.

4.4.5 Professional Advisers are not Statutorily Exempted from the Category of Shadow Director

The IA provides that a person is not deemed a shadow director by reason only that the directors act on advice given by that person in a professional capacity.[86] Of course, if they cross the line and move from advising to instructing this exemption will not protect them.[87]

No similar exemption exists in the Hungarian statute. The widely drafted definition[88] of shadow director may, in theory, include those who advised the debtor company in a professional capacity (e.g. solicitor or accountant). However, there are no apparent cases in which Hungarian courts established the liability of a professional adviser as shadow director.

Another aspect of the involvement of professional advisers is whether that has any effect on the liability of the director. In England, courts have been prepared to place weight upon the evidence as to whether the directors took professional advice, and if so, what that advice was.[89] It appears that asking for and following the advice of an informed professional is a strong defence against wrongful trading claims.[90] No similar case law appears to exist in Hungary.

4.5 Some further Critical Questions

4.5.1 The Question of "New Creditors"

One of the crucial, partially ethical, question emerging when a company operates on the verge of insolvency is the treatment of "new creditors". When a company continues operating after the critical date,[91] normally new debts incur. This is because, in order to generate revenues and performing its obligations *vis-à-vis*

86 Section 251, IA.

87 L. Doyle and A. Keay (eds.), Insolvency Legislation: Annotations and Commentary (2016, Jordan Publishing, Bristol) p. 380.

88 § 33/A(1), HIA.

89 *Hawkes Hill Publishing Co Ltd (In Liquidation), Re* [2007] BCC 937 az paragraph 43; *Continental Assurance Company of London plc* [2007] 2 BCLC 287 at paragraph 108; *Ralls Builders* [2016] EWHC 243 (Ch) at paragraph 176-177, 206.

90 F. Oditah, "Wrongful trading" (1990) Lloyd's Maritime and Commercial Law, p. 208.

91 In England when they know or should conclude that there no reasonable prospect to avoid insolvent liquidation and in Hungary when the director foresees or should reasonably foresee that the debtor company will not be able to satisfy its liabilities when due. See above under the heading *4.4.1 What should the director foresee?*

their partners, the debtor company more often than not needs to purchase material, order services, involve sub-contractors, accept new orders, etc. In principle, this is not contrary to the obligation of the director to take every step with a view to minimising the potential loss to the company's creditors in the critical period.[92] After all, if the trade out is successful and the company regains its solvency then no creditor's claims remain unpaid. However, in the event of a failure of rescue the new creditors, i.e. those whose debts arose during the critical period, find themselves in the situation as if they were, typically involuntarily, used to finance the attempt to rescue the debtor company at their own risk. Moreover, in several cases they have to face the fact that some of the "old creditors" (i.e. those whose claim arose prior to the critical period) were simply paid off from the money coming from the new creditors.

Some legal systems, e.g. the German, handles this question differently. When applying the German "counterpart" of wrongful trading provisions, the so-called *"Insolvenzverschleppungshaftung"* (liability for delaying insolvency), German courts distinguish between old and new creditors. While the former ones receive *"Quotenschaden"* (i.e. the diminution after comparing the hypothetical dividend that would have been payable to the creditors at the time when the company should have filed for insolvency and the actual dividend expressed as a percentage of the nominal claims), the new creditors generally retrieve their total losses which are not to be claimed by the liquidator.[93] In other words, when considering the damage has been caused by the delay in the commencement of the insolvency, German law focuses on the position of the creditors rather than the position of the company.[94]

By contrast, section 214 of the IA apparently looks at the loss suffered by the company, and consequently, by the general body of creditors, rather than the individual creditors. As Snowden J explained:

> "Standing back, whatever other criticisms can be made of the manner in which the Directors conducted the business of the Company [in the critical period], I think it is entirely plausible that such continued activity did not cause loss *to the Company overall or worsen the position of the creditors as a whole* [emphasis added]. The real sin of the Directors, so far as the unsecured creditors left in the liquidation are concerned, is the manner in which the continued trading facilitated the repayment of the Bank and some existing creditors whilst leaving

92 Section 214(3), IA; § 33/A(3), HIA.

93 Bachner, above note 28, 311 ff; Spindler, above note 17, p. 47.

94 *Ibid*, p. 311.

> new creditors unpaid. I have already indicated my view that this is not something that the Directors ought to have permitted to occur, but for the reasons I have explained, I cannot see that it justifies a contribution to be made to the assets of the Company under section 214(1). That may be thought to be a shortcoming in the structure of section 214 [the provision on wrongful trading], but I do not think it is one that I can remedy: any such change would be for Parliament."[95]

Having said that, this does not mean that the directors should irresponsibly use the new creditor's means to help the company survive or pay off some other due debts. Namely, such behaviour may trigger liability for fraudulent trading pursuant to section 213 IA.[96] In general, fraudulent trading is committed if the company obtains new credit, knowing it will be unable to repay it when due in order to pay off existing creditors.[97] The threshold of proof, of course, is higher as compared to that of wrongful trading. Namely, in order that the liability for fraudulent trading be established it is necessary to prove that the business has been carried out with intent to defraud creditors, that the defendant participated in carrying on the business, and that the defendant did so with knowledge about the fraudulent intention.

As with the English provisions, the Hungarian subspecies of wrongful trading also focuses on the interest of the general body of the creditors. The monetary limit of the compensation is the decrease of the asset pool of the debtor company in the period of the imminent insolvency.[98] Consequently, if there is no loss, there is no liability. Apparently, the current provisions of the liability for wrongful trading, like the English statute, are not designed to differentiate between "old" and "new" creditors.

But again, as with the English provisions, there is some protection for those creditors whose claims arose when there was virtually no chance that the debtor would be able to pay them off. Although there is no statutory rule in Hungary corresponding to English civil remedy of fraudulent trading, fraud as a general criminal offence appears to cover this kind of behaviour.[99]

95 *Ralls Builders* [2016] EWHC 243 (Ch) at paragraph 279.

96 Regarding the criminal liability for fraudulent trading see Section 993, Companies Act.

97 *R v Grantham* [1984] QB 675; Goode, above note 35, p. 661-662.

98 See above under the heading *4.3.5 The quantitative limit of the compensation*.

99 BH2011. 58. (Legf. Bír. Bfv. II. 1040/2009.)

4.5.2 Which Creditors can be Lawfully Paid off During the Critical Period?

We have seen before that section 214 of the IA is basically neutral regarding payment to selected creditors. What matters is the overall position of the company rather than the position of singular creditors. Similarly, fraudulent trading pursuant to section 213 of the IA is generally not implicated by payment of preferences. The mere fact of preferring one creditor will not in itself qualify as fraudulent trading.[100] Of course, other legal grounds for liability like the provisions on preferences[101] and misfeasance[102] may come into play.

In Hungary, there is a degree of uncertainty as to what constitutes the diminution of assets and which payments by the debtor, diminishing the asset pool, are deemed lawful. In several judgements, the question of the increase of the deficiency (i.e. the worsening of the position of the general body of creditors) on the one hand and that of the lawfulness of such increase on the other hand are not handled as separate questions. The following main directions can be distilled from case law.

The majority opinion, confirmed by the Curia suggests that wrongful trading provisions are designed to protect the assets of the debtor company.[103] Consequently, if the asset pool diminishes in the critical period, even if through paying off some legitimate debts to the creditors, this amounts to the diminution of assets for the purposes of the wrongful trading provisions. However, this does not necessarily mean that such diminution is unlawful, as we are going to see below.

A minority of the decisions concluded that in the event both the assets and the liabilities decreases, e.g. by paying off one or more legitimate creditors with due claims, this is not a diminution of assets for the purposes of wrongful trading.[104]

As to the question asking which creditors may lawfully be paid off in the critical period, even if at the price of diminishing the asset pool, diverging answers can be found in the case law. At the one end of the scale there are a few judgements concluding that no payment is allowed which diminishes the assets of the debtor company.[105] At the other end of the scale are those decisions ruling that payments

100 *Sarflax Ltd, Re* [1979] Ch 592.

101 Section 239, IA.

102 Section 212, IA; *Liquidator of West Mercia Safetywear Ltd v Dodd* [1988] 4 B.C.C. 30; Goode, above note 35, 652 f.

103 Kúria Gfv.VII.30.024/2015/4., Kúria Gfv.VII.30.265/2015/4., BH2016. 179. (Kúria Gfv. VII. 30.254/2015.), ÍH 2013.37. (Szegedi Ítélőtábla Gf. I. 30.344/2011.), Fővárosi Ítélőtábla 12.Gf.40.343/2012/7., Fővárosi Ítélőtábla 15.Gf.40.043/2015/5/II.

104 E.g. Debreceni Ítélőtábla Gf.III.30.387/2012/5; Pécsi Ítélőtábla Gf.IV.40.022/2015/4; Szegedi Ítélőtábla Gf.IV.30.105/2013/5.

105 Kúria Gfv.VII.30.265/2015/4; Legfelsőbb Bíróság Gfv.IX.30.432/2010/4.

to legitimate creditors, including shareholders, do not violate the prohibition of wrongful trading,[106] as long as both the assets and liabilities diminish in equivalent proportions.[107]

What appears to be the majority opinion is that payments to related persons (first of all to the shareholders of the debtor company) are not acceptable.[108] A number of judgements agree that from the point of view of the liability for wrongful trading a distinction must be made between outsider creditors on the one hand and the shareholders of the company. The repayment of the shareholder's loan may not frustrate the settlement of claims belonging to outsider third party creditors. Some judgements and authors have emphasised that a director, when deciding about payments to be performed during the critical period, should make sure that the specific payment serves the restoring of the solvency, the enabling of the continued operation, thus the interests of the general body of the creditors.[109]

Hungarian courts appear to accept that payments to those secured creditors whose claim would be covered by the assets anyway in a hypothetical insolvent liquidation scenario does not trigger liability for wrongful trading.[110]

As with the English law, the fact that some payments to selected creditors do not constitute wrongful trading liability does not mean that the payment in question would not be targeted by provisions on preferences.[111]

4.5.3 "Pull the Plug" Scenario

Sometimes a decision whether to continue the operation or to shut down the business can be difficult indeed. This is the situation if the company is insolvent or is in the state of imminent insolvency, the survival is rather questionable and the chances are that, if the attempt to trade out of insolvency turns out to be unsuccessful, then the general body of creditors finds itself in a situation worse than it would have been if the debtor had filed for insolvency earlier. What are directors expected to do in such situation?

106 But it may well be incompatible with the rules on preferences, see § 40, HIA.

107 Fővárosi Ítélőtábla 12.Gf.40.469/2013/5; Pécsi Ítélőtábla Gf.IV.30.117/2013/8; Pécsi Ítélőtábla Gf.IV.40.022/2015/4.

108 Kúria Gfv.VII.30.193/2013/8; Debreceni Ítélőtábla Gf.IV.30.008/2015/5; Szegedi Ítélőtábla Gf.III.30.401/2014/2; BDT2014. 3241 (Szegedi Ítélőtábla Gf. I. 30 509/2012); Győri Ítélőtábla Gf.II.20.117/2015/3; BDT2013. 2881 (Szegedi Ítélőtábla Gf. I. 30 276/2011.). Similarly, Csőke, above note 43, p. 132.

109 BDT2014. 3241 (Szegedi Ítélőtábla Gf. I. 30 509/2012); Győri Ítélőtábla Gf.II.20.117/2015/3; Debreceni Ítélőtábla Gf.IV.30.008/2015/5. Similarly, Csőke, above note 43, p. 132.

110 Kúria Gfv.VII.30.040/2012/3; ÍH 2013.37. (Szegedi Ítélőtábla Gf. I. 30.344/2011).

111 See § 40, HIA; BH2016. 179 (Kúria Gfv. VII. 30.254/2015); ÍH 2013.37 (Szegedi Ítélőtábla Gf. I. 30.344/2011); Pécsi Ítélőtábla Gf.IV.30.117/2013/8; Szegedi Ítélőtábla Gf.IV.30.105/2013/5.

The emblematic sentences of Park J., which sum up the diverging incentives influencing the decision of the managers, are worth citing in this regard:

> "An overall point which needs to be kept in mind throughout is that, whenever a company is in financial trouble and the directors have a difficult decision to make whether to close down and go into liquidation, or whether instead to trade on and hope to turn the corner, they can be in a real and unenviable dilemma. On the other hand, if they decide to trade on but things do not work out and the company, later rather sooner, goes into liquidation, they may find themselves in the situation of the respondents in this case—being sued for wrongful trading. On the other hand, if the directors decide to close down immediately and cause the company to go into an early liquidation, although they are not at risk of being sued for wrongful trading, they are at risk of being criticised on other grounds. A decision to close down will almost certainly mean that the ensuing liquidation will be an insolvent one. Apart from anything else liquidations are expensive operations, and in addition debtors are commonly obstructive about paying their debts to a company which is in liquidation. Many creditors of the company from a time before the liquidation are likely to find that their debts do not get paid in full. They will complain bitterly that the directors shut down too soon; they will say that the directors ought to have had more courage and kept going. If they had done, so the complaining creditors will say, the company probably would have survived and all of its debts would have been paid. Ceasing to trade and liquidating too soon can be stigmatised as the cowards' way out."[112]

What appears to be certain in the context of the English law is that there is, of course, no obligation to cease operating once the company becomes insolvent, even if the situation is so hopeless that there is no prospect of saving the company. In this case, the continuation of operations may still diminish the net deficiency so that the general body of creditors is better off than it would have been in the event of an early filing.[113] Even if the continued trading happened to increase the net deficiency, the director who tried to save the business may still have some chance to rely on the statutory defence by proving that he took every step with a

112 *Re Continental Assurance plc* [2001] BPIR 733 at paragraph 281.
113 *Ralls Builders* [2016] EWHC 243 (Ch) at paragraphs 185, 268-270.

view to minimising the potential loss to the creditors, assuming it was designed appropriately so as to minimise the risk of loss to individual creditors.[114]

The risks connected to the opposite situation, i.e. when the manager decides to stop trading and file for insolvency even though there was still reasonable prospect to avoid going into insolvent liquidation, is less clear. As we have seen above, Park J. seems to suggest that in this case directors are not at risk of being sued for wrongful trading.[115] This appears to be logical. Wrongful trading liability is attached to the continuation of trading in the critical period, i.e. when the director knew or ought to have concluded that insolvent liquidation cannot reasonably be avoided. If there is no such critical period or it is very short simply because the director filed for insolvency once the situation started to become critical, there appears to be no basis for the application of section 214 of the IA.

In Hungary, the "pull the plug" scenario is sometimes regarded as a safe harbour by advisers and directors striving to avoid personal liability for wrongful trading. Indeed, while on the one hand wrongful trading provisions do not seem to restrain directors from attempting to save debtor companies through continuing operation as long as the operation and the associated payments are not contrary to the interests of the general body of creditors, on the other hand, those provisions do not prohibit or penalise early filing, either. Having said that, directors may be liable *vis-à-vis* the company (thus indirectly to the shareholders and the creditors) on a legal basis different[116] from wrongful trading if they let the company go into insolvent liquidation despite the opportunity to dissolve the company through solvent liquidation proceedings.[117]

5 The Diverging Case Law

Despite the visibility of the wrongful trading concept both in England and abroad, section 214 of the IA has not been often used. There have only been a small number of reported cases.[118] What generally can be said about the case law is that courts do not appear prepared to impose liability on directors, and this is particularly so if the directors have sought and obtained advice from professionals. Accordingly,

114 *Ibid,* at paragraph 245.

115 Goode, above note 35, pp. 667, 673-674 is of the opposite view.

116 E.g. a derivative claim for compensation brought by the liquidator on behalf of the insolvent debtor company, § 3:24(1), Civil Code; or a shareholder's claim for compensation *vis-a-vis* the director, § 3:117(3), Civil Code.

117 BDT2012. 2782. (Szegedi Ítélőtábla Gf. I. 30 346/2011.)

118 A. Keay and P. Walton, Insolvency Law, Corporate and Personal (2012, Jordan Publishing, Bristol), p. 659.

in most cases where directors have been found liable they have been found to have acted *irresponsibly*.[119] As Park J. summarised:

> "Typically they have been cases [where directors have been held to be liable] in which the directors closed their eyes to the reality of the company's position, and carried on trading long after it should have been obvious to them that the company was insolvent and that there was no way out for it. In those cases the directors had been irresponsible, and had not made any genuine attempt to grapple with the company's real position."[120]

In *Produce Marketing,*[121] the directors ignored the warning of the auditors and continued trading. Beyond, the affairs of the debtor were conducted in a way which reduced the indebtedness to the bank, to which one of the directors had given a guarantee, at the expense of trade creditors. In *Re Purpoint,*[122] the director failed to ensure that proper records were kept and that proper cash flow calculations and net worth calculations were made, therefore it was impossible to ascertain the extent to which the net liabilities were increased by the continuance of the company's trading. In *Re Bangla Television,*[123] instead of causing the company to cease trading, the directors caused the company to deal or purportedly trade with its assets so that the company parted with £250,000 worth of them for no consideration.

By contrast, there have been a relatively high number of cases reported in Hungary in the recent years. It appears that more than 300 cases reached the courts of appeal, most of them after 2010. Taking into consideration the difference in size of the two countries, we can say that wrongful trading litigation is much more widespread in Hungary than it is in England. Based on the review of the cases, it can be said that in Hungary, a successful wrongful trading litigation presupposes an element of fraud in a wide sense, the term including preferential payments to affiliated entities as well.

Among other things,[124] Hungarian courts held directors liable who had repaid shareholders' loans in the critical period while no assets were available for

119 Morris v Bank of India [2005] EWCA Civ 693 at paragraph 103; *ibid*, p. 659.; A. Keay, above note 23, p. 130.; Doyle and Keay (eds.), above note 87, p. 298.

120 *Re Continental Assurance plc* [2001] BPIR 733 at paragraph 106.

121 *Produce Marketing Consortium (In Liquidation) Ltd, Re (No.2)* [1989] 5 BCC 569.

122 *Purpoint Ltd, Re* [1991] BCC 121.

123 *Bangla Television Ltd (In Liquidation), Re* [2009] EWHC 1632 (Ch).

124 On the behaviours of executives normally giving rise to personal liability see Summary Opinion, above note 44, pp. 21-23.

unsecured creditors.[125] Also, providing loans to affiliated companies and/or (asset-less) third parties without any security interests, thereby diminishing the asset pool available to the creditors, amounted to wrongful trading.[126] Similarly, directing payments originally due to the debtor company to another (affiliated) entity in the vicinity of insolvency may trigger the director's personal liability.[127] Entering into notional contracts in order to dissipate the debtor's assets[128] or a fraudulent transfer of real estate for no real consideration to another (affiliated) company[129] qualified as wrongful trading. Should the director be unable to give an account of the assets indicated in the annual accounts he has to be prepared to be subject to wrongful trading litigation, too.[130]

6 Possible Reasons For Diverging Case Law

As has been shown, there are significant differences in the case law between England and Hungary, both in terms of the number and the substance of the cases.

As to the low number of reported cases in England, the findings of the Leeds Report[131] are instructive. The Report identified a number of obstacles to enforcement vis-à-vis directors who breached their insolvency-related duties.[132] In relation to the United Kingdom, these obstacles seem to be: impecunious directors, cost of litigation, lack of evidence, burden of proof, and lack of funding. The problem of funding and the litigation costs as important obstacles are highlighted by other authors, as well. Because only office holders (liquidators and administrators) have the right to initiate the litigation and no public funding is available, they are rather cautious of risking the debtor's already inadequate assets on litigation unless there is a very strong chance of success.[133] Possibly, the reforms of 2015 giving office

125 BH2016. 179 (Kúria Gfv. VII. 30.254/2015); BDT2013. 2881 (Szegedi Ítélőtábla Gf. I. 30 276/2011); Debreceni Ítélőtábla Gf.IV.30.008/2015/5; Szegedi Ítélőtábla Gf.III.30.401/2014/2.

126 EBH2011. 2326 (Legf. Bír. Gfv. IX. 30.249/2010); Kúria Gfv.VII.30.253/2014/6; ÍH 2013.76 (Fővárosi Ítélőtábla 13. Gf. 40.002/2012/15); BDT2010. 2282 (Pécsi Ítélőtábla Gf. II. 30 266/2009/7); BDT2016. 3499. (Debreceni Ítélőtábla Gf. IV. 30 369/2015/6).

127 BH2014. 188 (Kúria Gfv. VII. 30.247/2013).

128 BH2012. 101 (Legf. Bír. Gfv. X. 30.361/2010); BH2013. 222 (Kúria Gfv. VII. 30 036/2013).

129 Fővárosi Ítélőtábla 12.Gf.40.013/2015/6-II.

130 Legfelsőbb Bíróság Gfv.IX.30.432/2010/4; BDT2008. 1767 (Szegedi Ítélőtábla: Gf. I. 30.099/2006).

131 Above note 20.

132 *Ibid*, pp. 62 ff.

133 Davies, Worthington and Micheler, above note 80, pp. 217-218; Keay and Walton, above note 118, pp. 659-660. The abolition of the "Jackson exemption" for insolvency in April 2016 is expected to have a negative impact on the insolvency litigation in the UK, see Walton Report, above note 24, p. 11. By contrast, the new section 15A of the Company Directors Disqualification Act 1986 creates a new alternative way of director's liability by giving the court a new power to make a compensatory award against a director at the time it makes a disqualification order.

holders the statutory right to assign wrongful trading claims or the proceeds of such action[134] will somewhat improve the situation.

In relation to Hungary, the Leeds Report mentioned all the obstacles identified in relation to England plus a time factor. Without calling into question that all of these factors may play some role in the initiation of wrongful trading litigation, it must be noted that the high number of cases in Hungary seem to suggest the relative insignificance of such obstacles. The huge gap in terms of the number of cases heard in England and Hungary necessitates some explanation, however.

First of all, the Hungarian wrongful trading litigation is not reserved for office holders. By contrast, both the liquidator and any creditor have the right to bring actions for a declaration of liability for wrongful trading.[135] In reality, a significant percentage of the reported cases were commenced by creditors, not infrequently by the tax authority.[136] The fact that the pool of the claimants is bigger may increase the number of cases by itself. Beyond this, in some cases the wide pool of the potential claimants, particularly those with "deep pockets" like the tax authority, contributes to overcoming obstacles like the lack of funding and the costs of litigation. Also, the relatively modest cost of the litigation may be a factor contributing to the popularity of this remedy in Hungary.[137]

Beyond these above points of a somewhat "technical" nature, there are also some substantive differences that may potentially explain the high number of cases. In this regard two main factors should be referred to. First, as we have seen above, the level of knowledge "expected" from directors, i.e. what they could or should have been able to foresee, is rather different in Hungary from the English model. While in England, in order to activate liability for wrongful trading, it is necessary that the director knew or ought to have concluded that there was no reasonable prospect to avoid going into insolvent liquidation or administration (on balance sheet basis), while in Hungary a much lower level of knowledge suffices: the period of imminent insolvency begins when the directors were or should have been reasonably able to foresee that the debtor company would not be able to satisfy its liabilities when due (on cash-flow basis). As a consequence, this element of the wrongful trading materialises frequently. Second, the statutory presumption in Hungary, according

134 Section 246ZD, IA; Davies, Worthington and Micheler, above note 80, pp. 218.

135 § 33/A(1), HIA.

136 Summary Opinion, above note 44, p. 16; R. Muzsalyi, "A joggyakorlat-elemző csoport által vizsgált ítéletek alapján levonható statisztikai következtetések [Statistical Conclusions from the Judgements Analysed by the Expert Group]" (2016) (Annex No 9 to the Summary Opinion), pp. 99-104.

137 The stamp duty to be paid for the first instance declaratory action is approx. GBP 100. See §§ 39 and 42, Act XCIII of 1990 on Duties; 1/2013. (II. 28.) Polgári jogegységi határozat [Civil uniformity decision].

to which the violation of the interests of the creditors is presumed if the director has not deposited and published the debtor's annual accounts prior to the opening of liquidation proceedings or breached his obligation to cooperate with the liquidator and to provide him with the relevant information and documentation, plays an important role in a not insignificant number of wrongful trading litigations.[138]

Looking at the substances of the cases it can be observed that most (if not all) of the cases where the courts have established the personal liability for wrongful trading involved an element of fraudulence by the director. However, this element of fraudulence is to be understood widely: cases in which the defendant prioritised affiliated entities or shareholders over outsider creditors seem to suffice to trigger the liability for wrongful trading, assuming the further ingredients are also present.[139]

It appears that the implementation of the wrongful trading provisions in Hungary making possible to sue former directors for compensation of the damage caused to the creditors of the company during the period of imminent insolvency opened an invisible door for lawsuits against directors. This is most probably because prior to the implementation of the rules on wrongful trading there were no efficient civil law remedies protecting the interests of the creditors in the vicinity of the insolvency.[140] Undoubtedly, liquidators had been (and still are) free to initiate a kind of derivative claim for compensation in the right of the insolvent company.[141] However, the scope of those derivative actions are somewhat different from the wrongful trading actions. The prohibition of wrongful trading is designed to protect the interests

138 E.g. BH2012. 101 (Legf. Bír. Gfv. X. 30.361/2010); Kúria Gfv.VII.30.059/2015/5; Kúria Gfv.VII.30.024/2015/4; ÍH 2013.37 (Szegedi Ítélőtábla Gf. I. 30.344/2011); ÍH 2013.76 (Fővárosi Ítélőtábla 13. Gf. 40.002/2012/15); BDT2012. 2619. (Szegedi Ítélőtábla Pf. I. 20.498/2010); Fővárosi Ítélőtábla 12.Gf.40.013/2015/6-II; Fővárosi Ítélőtábla 15.Gf.40.043/2015/5/II. In around 36% of the cases the statutory presumption applies, see Lakatos, above note 76, p. 82.

139 See above under the heading *5 The diverging case law*.

140 2006. évi VI. törvény indokolása a csődeljárásról, a felszámolási eljárásról és a végelszámolásról szóló 1991. évi XLIX. törvény módosításáról [Statement of reasons given for the Act VI of 2006 amending the HIA]. Having said that, in some cases courts have decided to lift the corporate veil on the basis of the general civil law declaring that the defendant-directors abused the shield of limited liability. See Szegedi Ítélőtábla Polgári Kollégium 2/2008 (XII. 4) számú kollégiumi véleményével módosított, egységes szerkezetbe foglalt 1/2005. (VI. 17) számú kollégiumi véleménye a jogi személy elkülönült felelősségéről és a felelősség „áttöréséről" [1/2005 (VI. 17) opinion of the Regional Court of Appeal Szeged (Civil Division) about the separate liability and the "lifting of the corporate veil" as amended and consolidated by 2/2008 (XII. 4) opinion of the same court]; BDT2002. 631 (Csongrád Megyei Bíróság 1. Gf. 40 298/1999/3); BDT2012. 2707 (Szegedi Ítélőtábla Gf. I. 30 146/2011). Some authors argue that this case law is *contra legem*, see Sz. Patai and S. É. Szabó, "A működő jogi személy elkülönült felelősségének áttörése az EDB 2014.11.G3. ítélet tükrében [Lifting of the corporate veil of an operative (i.e. non-insolvent) company in the light of decision EDB 2014.11.G3]", (2016) (3) Polgári Jog [electronic journal]. After the entering into force of the new Civil Code this case law appears to be unsustainable, see P. Gárdos and L. Vékás (eds), Kommentár a Polgári Törvénykönyvről Szóló 2013. évi V. törvényhez [Commentary on the Civil Code] (2014, Wolters Kluwer, Budapest) [electronic edition], Chapter LXIX.

141 § 3:24(1), Civil Code.

of the creditors by making directors liable for the diminution of the asset pool, thus for losses suffered, indirectly, by the unsecured creditors in the period of imminent insolvency. By contrast, the derivative action initiated by the liquidator on behalf of the company is designed to make the directors liable for losses caused to the company itself. In the latter case the fact that the directors disregarded the interests of the creditors is irrelevant. Consequently, it is more than questionable whether a director following the instructions of the majority shareholder or acting in compliance with the resolutions of the shareholder's meeting could be held liable, without the special rules on wrongful trading, for losses suffered by the company. E.g. paying off due and lawful shareholder's loans prior to outsider commercial creditors, while this is apparently a violation of the wrongful trading rules, it seems to be out of the scope of the derivative compensatory action.[142]

7 Some Conclusions

Should the Hungarian legislation on wrongful trading therefore be regarded as a legal transplant of its English counterpart? The answer is yes, with some reservations. It was the apparent decision of the Hungarian legislature to create special rules on director's liability *vis-à-vis* creditors in the context of insolvency. Both the wording and certain basic ingredients of the Hungarian provisions suggest that the Hungarian rules were inspired by the English example. Both provisions are intended to protect creditors' interests in the vicinity of insolvency, the basis of the liability is the loss caused to the creditors in the critical period, the starting point of the liability, at least in theory, precedes the factual insolvency etc. On the other hand, on at least at one crucial point, the Hungarian legislator deviated from the English template. In England, the insolvent trading in itself does not trigger personal liability. Should the director reasonably believe that the company can trade out of difficulties, so that balance sheet insolvency is avoidable, there is no liability. By contrast, in Hungary the mere knowledge or anticipated knowledge about an, even temporary, cash-flow insolvency is enough for directors to enter into the danger zone.

The differences in the case law, first of all in terms of the quantity of cases in Hungary appears to be attributable, principally, to the broader pool of the potential defendants stemming from the widely formulated statutory provisions regarding the critical period, the broader pool of the claimants arising from the legal standing

142 By contrast, there appear to be misconducts which may trigger either types of liability; see BDT2013. 2897 (Debreceni Ítélőtábla Gf. III. 30 617/2012/6); BDT2008. 1767 (Szegedi Ítélőtábla: Gf. I. 30.099/2006); EBH2011. 2417 (Legf. Bír. Pfv. X. 21.462/2011).

of creditors, the statutory presumption supporting the claimants' case and the modest litigation costs.

However, if we have a look at the substantially different nature of the case law, it becomes apparent that this may not follow from the differences of the statutory provisions. As we have seen, while English directors are normally found liable where they have acted irresponsibly, in Hungary courts tend to hold directors personally liable when an element of fraudulence in a wide sense can be detected. At the first sight, it may seem a paradox that the caseload is more substantial in Hungary despite the higher threshold of misconduct (fraudulence instead of irresponsibility). However, the real reason behind this phenomenon is probably different. It appears, that the provisions on the personal liability of directors for wrongful trading, imported by Hungary back in 2006 with no ancestors in the Hungarian law, have found their place in the Hungarian legal system covering a wider circle of misconduct and incorporating actions which would fall within the scope of other actions in England, first of all that of the fraudulent trading or misfeasance.[143] This demonstrates that the transfer of certain legal institutions from one country to another without having regard to the wider context of the legal systems, however successful they are, does not necessarily result in legal harmonisation. Perhaps the term "legal naturalisation" may be more appropriate to describe the story of the liability for wrongful trading in Hungary.

143 See above note 24.