CHSHCEE Newsletter Hungary

New rules on the liability of ex-directors of failed companies

An amendment to Hungary's Bankruptcy Act has introduced new rules applicable to lawsuits that are filed in "findings" and "award" procedures after 1 July 2017. The changes are two-pronged: on the one hand, the rules on exemptions have become more restrictive, but on the other, creditors should not be too happy either because some of the rules now make it harder for them to recover their claims.

In short, management liability as regulated under Section 33(A) of the Bankruptcy Act means that the creditors of a company that is subject to compulsory liquidation may seek to recover debts owed to them directly from the company's director if the director is liable for the fact that the creditor's claims cannot be satisfied. A director is a person who directed the company's operation and disposed over its assets before the start of its compulsory liquidation (i.e. not only executive officers who are recorded in the company register, but shadow directors as well). If a director of a company that has become or is close to becoming insolvent makes decisions or takes actions that prevent the company's creditors from fully recovering their claims, the creditors will be able to seek satisfaction of their claims from the director's private assets. Such decisions and actions typically include making unsecured loans to companies with liquidity problems, the sale of the company's assets in exchange for unrecoverable debts, or a situation where the director cannot account for the company's assets. A director may be instructed by a court to pay off the company's creditors in a two-stage procedure: in the first stage, it is established whether the director is indeed liable for the situation (the "findings" procedure), and if the director is found liable, the court instructs him or her to make the payment (the "award" procedure). Another special feature of this combined process is that the petitioners in the findings procedure and the award procedure are not necessarily one and the same. The court may establish the director's liability on the basis of a lawsuit filed by a single creditor, and then the director will be required to make a payment to all creditors who/which have not received the full amount of their claim in the compulsory liquidation procedure and have initiated an award procedure.

The amendment once again means creditors are unable to file a lawsuit against directors during the compulsory liquidation procedure on the basis of an interim balance sheet. Additionally, the deadline to file a lawsuit in an award procedure has been extended from 60 to 90 days after the judgment is made in a findings procedure,

and the liquidator is now required to inform all creditors that a findings procedure has been initiated against a director. The purpose of these modifications is to protect the interests of creditors who do not participate in the findings procedure.

The modifications make it clear that the purpose of a findings procedure is to determine whether the director had regard for the interests of the creditors after the situation that threatened the company with insolvency first arose, i.e. whether he or she took action to prevent the reduction in the value of the assets available for the payment of creditors. If the director did not comply with this duty and the value of the company’s assets diminished, or he or she otherwise created a situation that prevented the full satisfaction of all creditors’ claims, the director will held liable and pay such claims from his or her own private property. However, any payment that reduces the value of a company’s assets (e.g. the ongoing payment of accounting fees) will also reduce the value of assets available for satisfying the creditors’ claims, and therefore, as a result of the modification, directors will be exempt from liability not only if they can prove that they took all reasonable steps to avoid losses and requested action from the company’s main decision-making body, but also if they can prove that the payments did not constitute unreasonable risks in light of the company’s financial situation. Consequently, the Bankruptcy Act now implies that actions involving unreasonable risks violate the creditors’ interests (a typical example would be unsecured lending as noted above).

The rule that makes it difficult for directors to seek exemption from liability if they failed to publish the annual report or deposit it with the court of registration remains in place. The Bankruptcy Act now makes it clear that the strict rules apply not only if a director did not prepare or publish the annual report but also if he or she did not comply with this obligation properly. On the other hand, the stricter rules will only apply to a failure to fulfil these obligations if the director is at fault for such non-compliance.

There is a major change in the way in which the security that can be requested in a findings procedure is regulated. The purpose of this modification is to secure the claims of the creditors who bring an action against directors in the follow-up award procedure. The modification does indeed offer stronger protection for creditors, but it also adds extra requirements that they or the liquidator have to meet in the award procedure. Under the previous rules, the determination that a director was liable, or

even the likelihood of such determination, was enough to require him or her to provide security (on the grounds that the existence of liability reasonably raised the prospect that the director might not be willing to pay at the end of the award procedure). However, from now on creditors or the liquidator must provide evidence why the court should instruct the director to provide such security. The Bankruptcy Act does not offer any guidance about what such evidence should be, and courts will probably use the rules on interlocutory injunctions or precautionary measures as a starting point. In our view, however, it is highly questionable how liquidators and creditors, who generally have no access to the relevant information and evidence, will be able to meet this extra requirement. On the other hand, the position, also espoused by the Supreme Court, that a request for the provision of security can be filed at any time during the findings procedure and that the court must make a decision on such a request in an expedited procedure (rather than only in the final judgment issued in the case) is now regulated in the Bankruptcy Act. The purpose of the incorporation of this rule in the Act is to neutralise a drawback of the two-phase procedure because creditors often end up after years of litigation with nothing more than a moral victory and no money recovered.

Finally, the modification makes it clear that the various levels of priority in which the creditors’ claims are satisfied in a compulsory liquidation procedure will not apply in an award procedure, i.e. the various priority categories dissolve and the petitioners in the award procedure (i.e. creditors who did not receive any payment from the debtor and filed the lawsuit in the award procedure) will proportionately share the security, which must be provided in cash by the director after the establishment procedure is concluded.

In summary, the modification of the rule on the liability of directors is certainly welcome, but it is likely to fall short of the goal of bringing to account directors who engage in wrongful trading because they tend to exhibit great creativity in avoiding liability. Additionally, the prohibition of seeking an award on the basis of an interim balance sheet and the introduction of stricter rules on securities will reduce the chances of creditors recovering their claims.

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