IS THE LIMITED LIABILITY DOCTRINE APPLICABLE TO COMPANY DIRECTORS?

Virginijus Bite, Assoc. Prof. Dr.
Gintare Jakuntaviciute, Dr.
Mykolas Romeris University, Lithuania

Abstract

At all times the majority of directors, which desired to properly perform and develop activities on behalf of a company in a competitive market, were raising relevant questions on how to control a company aiming to guarantee and ensure its financial viability and competitiveness, what is the line between the freedom of decision-making and personal liability therefore, are the directors equally as the shareholders protected under the limited liability doctrine? The prevailing opinion is that principle of limited liability protects shareholders and only shareholders from liability. Therefore, in this study the authors explore this premise from the perspective of the doctrinal implications of immunising directors from personal liability for their actions, when managing company's affairs.

The authors' principal conclusions are that the limited liability doctrine should be applied not only to the shareholders, but also in respect of the directors. Such legal protection from the liability could be withdrawn, when a director commits illegal acts that cause damages to a company or to creditors thereof. In respect of creditors the liability of such director shall still be considered subsidiary, whereas a direct liability of the director may only arise against a company until its liquidation and only after the completion of liquidation proceedings – against the creditors whose claims remained unsatisfied.

Keywords: Limited Liability, Personal Liability, Company Director, Creditor, Insolvency

Introduction

The fundamental attribute of company's legal personality from which indeed all other consequences flow is that the company is a legal entity distinct from its shareholders. Hence it is capable of enjoying rights and of being subject to duties which are not the same as those enjoyed or borne by its shareholders. Therefore, in the absence of express provision to the

contrary the shareholders will be completely free from any personal liability for the company's debts. In principle, a private company with liability limited by shares offers shareholder protection by limiting liability to the nominal value of their shares. This means that while a private company may incur liability in excess of its assets, ordinarily, shareholder liability extends only to the nominal value of the shares. Public policy has dictated certain and limited exceptions to the principle (referred to collectively as instances of "*piercing the corporate veil*"). Where the corporate veil is pierced, shareholders may be pursued for the liabilities of a company beyond the nominal value of their shares. For example, the Lithuanian piercing of corporate veil provision is stipulated in the Civil Code of the Republic of Lithuania (the "Civil Code"), indicating that the shareholders of the company are subsidiary liable (for the company's obligations) in situations where the company may not settle with its creditors because of the unfair acts of its shareholders. Hence the principle of separate legal personality is assumed to be principally about protecting investment of shareholders in the business. Thus, it is the shareholders and only shareholders who may hide behind the veil of incorporation and there is no single opinion in any scientific literature with regard to the question, whether the company's directors shall be also entitled to such limited liability defense.

Nowadays legal systems are seeking to protect companies from unlawful decisions of the directors and to oblige to take the personal liability for them. However, determination of strict liability standards for the adopted decisions would decrease their effectiveness and would limit the development of activities of the companies, as well as development of the state economy, because the directors would try to avoid innovations, and conversely, would try not to invest and take responsibility. However, in case the directors would not be subject to legal liability for the damages incurred due to their decisions made, that would increase the risk that the directors would adopt unlawful decisions.

Therefore, in this study we will consider whether and to what extent the principle of limited liability is or could be applicable to the company directors, by analysing the need of application of limited liability doctrine in respect of directors and determining on what legal basis directors are liable to the company and creditors for their illegal acts, which caused the damage.

The Limits of Limited Liability for Company Directors

As it was mentioned above, in a broad sense, the company's limited liability doctrine means that the satisfaction of the third parties' claims is limited to the extent of the company's assets (Art. 2.50(1) of the Civil Code). The main purpose of the applicability of limited liability doctrine is related to the development of a business friendly legal environment, also national

economy expansion, upon encouraging individuals to invest their financial and human capital to the company's activities without any potential risk to lose their own wealth. However, this defense of limited liability doctrine at the same time may establish favorable conditions for certain fraudulent activities of the company's shareholders or management body members in respect to the company's creditors, since without having any fears to lose their personal property, they may initiate or implement too risky projects, start wasting company's assets, etc. (Resolution of Supreme Court of Lithuania adopted in civil case No. 3K-3-581/2013, 2013). For these reasons, in order to reduce such risk of abusing company's limited liability, in the different legal systems around the world, a wide range of measures of various nature and scope, aimed at protecting the creditor's rights and legal interests are being enforced, for instance, subsidiary liability of the company's shareholders for the loss of creditors incurred due to unfair actions thereof, fiduciary duties of the management body members towards the creditors in case of insolvency of a company, rules of capital adequacy and so on.

Since the doctrine of a company's limited liability was created exclusively for the legal protection of shareholders' interests, there is no single opinion in any scientific literature with regard to the question, whether the company's management body members shall be also entitled to such defense on limitation of their liability. According to L. P. Davies, limited liability doctrine shall provide the same legal protection to the property of the company's management body members who act in the name of and on behalf of a company, as it is being applied to the shareholders' assets (Davies, 2002). The same position has been followed also in practice of Supreme Court of Lithuania (Resolution adopted in civil case No. 3K-3-19/2012, 2012) and the legal doctrine (Tikniūtė, 2006; etc.). It is being argued, that such extension of legal defense in favor of the company's directors is not in any way incompatible with the fundamental doctrinal functions set forth at the company law (Grantham, 2007), according to which only the company itself shall be deemed liable for contracts concluded in the name thereof or any torts committed on its behalf (Reynolds, 2006, pp. 99). It is recognized that the management body members as much as shareholders invest their wealth in the company; therefore, same as shareholders, they should also risk only the invested portion of their wealth. "In the case of shareholders that wealth takes the form of financial capital. In the case of directors, the wealth invested takes the form of human capital" (Grantham, 2007). This human capital, which consists of respective skills, technical know-how, management expertise and general income earning potential, might be considered as very specific and thus not easily re-invested elsewhere (Glynn, 2004). Furthermore, the human capital by its nature is

hardly diversified, as for „most executive directors, it is impossible as a matter of practicality to invest in developing firm-specific skills and *know-how* in a number of different businesses at the same time (Grantham, 2007). Thus, both shareholders and directors incur risk of losing direct investments in the event of company's business failure. Without being granted limited liability defense, shareholders would avoid to invest their financial capital into the company, same as directors – to use their human capital for the purposes of certain risky projects that could lead to their personal liability (Cheffins, 2002). As well, fear of personal liability would encourage directors to invest more into any available precautionary measures (Lacobucci, 2001), such as, civil liability insurance, monitoring activities, hiring external consultants and so on, which respectively would require a considerable portion of additional time and costs inputs. Furthermore, which could have a negative impact on prompt decision-making and, accordingly, this could threaten company's abilities to exhaust any and all available options to develop its business.

Applicability of limited liability doctrine in respect to the company's directors is being criticized by emphasizing that it would undermine an existing stable balance between risks and obligations that it is now supported by imposing directors' personal liability (Mendelson, 2002). It is also being argued that the limited liability of shareholders could encourage them to engage into more risky investment strategies and, if it is not being restricted in such way, this may lead to too much of the risk being externalized to creditors and other groups, and respectively, result in increase of net social costs, while director's personal liability could serve as a pragmatic constraint towards such shareholders' moral hazard (Glynn, 2004). Even though these arguments are indeed weighty, but still they do create certain doubts. In particular, if excessive risk taking is certainly a negative side relating to the limited liability, it is not very clear, why applicability of unlimited liability in respect to the company's directors is considered as the most sophisticated solution of this problem. As was already mentioned, unlimited liability may have an impact towards the director's sub-optimal decision making, which accordingly may have negative impact on the company's entire business development. But having in mind, that the aforementioned balance has to be kept, it is unclear, why a waiver of director's limited liability is considered as the best measure for such balance support. Certainly this can be also achieved upon directly taking into account not only advantages attributed to the company as the most favorable form of business organization, but also upon enforcing other efficient legal protection measures, such as, for instance, the anticipation of director's personal liability for company's debts when any transactions are being concluded in a state of company's

insolvency, provided, it can be proven that such director knew that the company will not be able to settle payments towards the creditors, and so on.

Critics of limited liability doctrine also state that there are other more efficient legal measures that may ensure that the director is indemnified from incurring personal liability. One of such measures is a civil insurance that is being purchased and maintained by a company itself (Baxter, 1995). It is being argued that such type of insurance granted for directors is similar to the limited liability defense as it also indemnifies directors from personal liability against the third parties, by shifting that risk through the company to the insurer (Grantham, 2007). The question arises, whether such type of insurance or the applicability of limited liability doctrine could be more efficient measure when protecting directors from their personal liability. More likely that still the limited liability would be more effective legal measure, in particular, due to the fact that in such case certain additional costs would be avoided, for instance, such as transaction costs related to the insurance policy negotiations, *ex post* costs associated with the possible litigation procedures and notification costs, related to the company's obligation towards the third parties to ensure that the director possesses required insurance coverage. Upon applying limited liability regime it would be clear that pursuant to the common rule the liability for obligations would fall on the company itself. Moreover, the empirical study of C. Baxter has shown that the civil liability insurance of the management body members in majority of cases has encouraged initiation of litigation proceedings, expecting the insurer to satisfy the respective claim in its entirety, unlike in other cases where the defendant was the individual director of the company (Baxter, 1995). Certainly, the main advantage of obtaining such insurance is the fact, that in the respective cases it is much more likely that victims of torts will receive applicable compensation of their losses (Finch, 2002); however, the aforementioned transaction costs still may mitigate such advantage. Moreover, the insurers usually are very active in litigation proceedings and exhaust all available measures to oppose the arguments stated in the claim (Baxter, 1995). Finally, it is also obvious that possession of such civil liability insurance might encourage the company's director's endeavors to engage into higher risk projects, and since the insurer may always monitor director's actions and respectively reduce the scope of insurance applicability or increase insurance contributions, this respectively may negatively impact director's efforts aimed at implementing more risky but beneficial projects for company's development (Baxter, 1995). Moreover, directors may refuse to remain at such posts without having civil liability insurance and may start reasoning their business decisions based on the scope of protection guaranteed by the possessed insurance coverage instead of referring to the company's business interests (Grantham, 2007).

O. Kahn-Freund criticizes such option of applying limited liability principle in respect to management body members of a company, emphasizing, that in such way certain legal presumptions are being created, allowing to indemnify directors from their respective liability for unlawful actions, which they were directly in charge of, and, accordingly, such situation creates immoral connotations within the business world (Kahn-Freund, 1994). The other authors support applicability of limited liability principle in favor of director only in case of creditor's claims arising under the contracts, but they clearly state, that such limited liability defense in any way should not be applied in respect to the director's liability arising in tort cases. Based on such authors, director must be personally liable for his committed torts, even if such actions were performed on behalf of a company, during enforcement of his managerial duties (Spender, 2005). However, we could agree with L. P. Davies' opinion that torts committed by the management body members that are entitled to act on behalf of a company, in the course of performance of their duties on behalf of the company within the limits of their competence, should not incur any personal liability, because such actions thereof should be deemed as actions of a company and a company itself shall incur full liability for losses caused to any third person due to such actions (Davies, 2002). Personal liability of directors may arise only in the event of failure to comply with the aforementioned criteria. Thus, it can be concluded that limited liability defense shall be applicable on the management body members in respect to both – contractual and tortious liability (Grantham, 2007).

It shall be also drawn attention to the fact that seeking to define, whether directors may incur personal liability for the company's obligations, courts in common law countries apply the following two key tests (Anderson, 2004). First of all, directors are held personally liable for their own unlawful acts, which cannot be assigned to the company actions (this test was applied in such cases as *Williams v. Natural Life Health Foods Ltd*, 1997; *Re Supply of Ready Mix Concrete*; *Revenue and Customs Comrs v Benton-Diggin*, 1995; etc.). This test foresees that the director will be imposed liability for any tort committed on his own name, for instance, when deceptively acting through another company seeking to avoid payment of taxes imposed on his managed company, as well as for any actions performed in favor of his own interests or in any other unjust way (Ribstein, 2002). Secondly, director would be held personally liable if he assumed such personal liability for company's actions (this test was applied in such cases as (*Trevor Ivory Ltd v Anderson*, 1992; *Hedley Byrne & Co Ltd v. Heller & Partners*, 1964; etc.). For instance, *in UK* directors may be imposed personal liability in cases, where they personally guarantee for the implementation of company's obligations under respective contract concluded with the third

parties (*Static Control Components (Europe) Limited v Egan*, 2004) or when a director did not explicitly indicate to such third persons that he was acting on behalf of a company but not in his own name. As well, it should be emphasized, that similar cases involving non-executive directors are less likely to occur, therefore, their personal liability for torts are very limited (Griffin, 1999).

In *German company law* it is determined the director's liability for each culpable violation of his duties. Such duties may originate from a contract (articles of association or director's employment contract) or from law (civil, corporate, criminal or insolvency law). A director's liability may lead to damage claims from the company (so-called internal liability) or to damage claims of the company's creditors or any third party negatively affected by tort (so-called 'external liability') (Loos, 2006). Managers may be imposed personal liability only in certain circumstances. For instance, when managers are acting in the name of a company, but do not notify or indicate such fact to the others or when the respective third party during the contract negotiation or signing procedures was acting in confidence in respect to one or several directors but he was not notified on the fact, that the company is currently deeply indebted and it would not be able to complete this transaction that will result in his further loss. Such liability for directors arises due to so called 'fault in contracting' (lat. *culpa in contrahendo*) (Lutter and Hommelhof, 2000).

Under *Belgium law,* a respective theory of quasi-immunity of agents is being applied, pursuant to which the directors executing a contractual obligation of a company cannot be held personally liable on a tort basis, unless: (i) they violated the duty of due care and diligence; and (ii) the fault caused a damage other than the damage caused by the poor execution of the mandate. Third parties, including creditors and shareholders, can then hold directors personally liable for all damages suffered due to the violation of a specific legal provision or the general duty of due care and diligence (Nieuwdorp and Roeck, 2006).

Pursuant to the *Lithuanian law,* such legal basis to apply civil liability in respect to the head of a company before the third parties has been established under Article 6.263 of the Civil Code thereof, where the general tort principle has been determined, establishing a common duty for a person to act carefully and with due diligence, in respect to unlimited number of the third parties. On the one hand, general tort principle is a provision, allowing to impose civil liability on a company's director against the third parties, but, on the other hand, such unrestricted applicability of this principle can be dangerous to the entire system of company law, as each person, who claims that he allegedly suffered loss due to company's director's actions can be considered as a rightful claimant (Didžiulis, 2008). Therefore, the limits for

applying this principle in respect to the company's director must be established by courts on case by case basis, since the company's director liability towards the third parties may arise only in cases, when a company itself is not capable to satisfy such third party claims (Resolution of the Supreme Court of Lithuania adopted in civil case No. 3K-3-295/2008, 2008). This implies that the company's director has a subsidiary liability in respect to the third party claims (Resolution of the Supreme Court of Lithuania adopted in civil case No. 3K-3-290/2013, 2013). Such liability is possible only when the director intentionally expresses his own will as a separate person, for instance, by issuing personal guarantees in respect to the company's undertakings, but in such case, the head of the company would be liable as a separate independent natural person but not as the management body of a company.

L. Doyle has a critical approach towards granting such rights for the creditor for submission of a direct lawsuit against the director of a company, because: 1) creditor may enforce all such available measures during company's bankruptcy or liquidation proceedings; and 2) creditor possesses all options *ex ante* to assess the risks and benefits of concluded transactions and may demand from a company to enforce any available measures aimed for securing such obligations, for instance, such as mortgage, deed of guarantee, etc. (Doyle, 2010).

Summarizing the aforementioned approach of scientists in respect to applicability of limited liability doctrine towards the directors, the following three groups based on the system of scientific theories indentified by L. Didžiulis may be determined: 1) *repression theory*, which supporters agree on determination of fiduciary duties in favor of creditors, because, firstly, such created loss shall be reimbursed by persons who are liable for causing thereof, secondly, a fear of personal liability might act as a powerful precautionary measure against the opportunistic behavior of directors; 2) *restriction theory*, which supporters, in opposite, state that (i) corporate law shall take care for safeguarding the shareholders' interests as a whole (first of all, maximization of profit), while the protection of creditors' rights shall remain subject to the provisions of a bankruptcy law, which general is enforced for the purpose of management of such critical situations and identifying of possible solutions; (ii) responsibility of directors to protect creditors' interests distorts the structure of stock ownership, which represents the idea, that the economical owners of a company are the respective participants thereof, and this contradicts to the principle of inviolability of a private property; (iii) a fear of civil liability may cause the director to become too precautious, which is obviously not compatible with one of the key business elements – such as risk; and 3) *limited liability theory*, which supporters states, that creditors should not initiate lawsuits against directors,

because the respective creditors, before entering into contractual relations with the company, have all possibilities to assess risks of their possible unsatisfied claims (Didžiulis, 2008).

We do support the view, that limited liability doctrine shall be applicable not only in respect to shareholders of a company, but also towards management body members thereof. However, such liability defense against the company could be lost in the event of tort, committed in breach of respective competencies or determined duties of such management body member. Respectively, in majority of countries around the world, it is allowed for the creditors to impose certain personal liability on the management body members when a company becomes insolvent – this issue will be more precisely analyzed in further sections hereunder.

Impact of Doctrines of "*Liability for Delaying Insolvency Proceedings*" and "*Deepening Insolvency*" Towards a Legal Status of Company Directors

In scientific literature there are distinguished two currently globally dominant legal doctrines, based on which it is being grounded the imposition of a civil liability on directors before the creditors, when a company becomes insolvent [32]. These are *doctrine of* '*liability for delaying insolvency proceedings*' and *doctrine of* '*deepening insolvency*' (Schillig, 2009 and 2010).

***Doctrine of* '*liability for delaying insolvency proceedings*'** is widely used and applied in the civil law countries. Initial sources in applying such doctrine might be found in Germany, where this doctrine was applied since the end of XIX century, towards the joint-stock, limited liability companies and cooperatives, and since 2008 it was applied towards all types of limited liability legal entities (Ulmer, Habersack and Winter, 2008; Schmidt, 2010). The main purpose of this doctrine is to establish at law such duty for timely

---

[32] In Western states, it is much wider used term "*insolvency*", than "*bankruptcy*", because of existing approach that *bankruptcy* is mainly related to criminal legal outcomes incurred as a result of *insolvency*. In USA, person, in respect to which the insolvency proceedings are being initiated, shall be firstly announced as insolvent, and subsequently, after the court ruling is adopted, it may be recognized as bankrupted. In UK, term "*bankruptcy*" is used, when speaking about natural persons, while in respect to legal entities it is used "*insolvency*" term. In German law there are two terms: *Zahlungsunfähigkeit,* which means *insolvency*, and *Insolvenz*, which might be interpreted in both meanings – *insolvency* or *bankruptcy*. In this country *insolvency* is one of the main legal grounds for initiating *bankruptcy* proceedings. In recent Russian laws, "*insolvency*" and "*bankruptcy*" terms are mainly used as synonyms. In Lithuanian laws it is being distinguished two types of *insolvency* – factual and legal. Factual *insolvency* – is understood as inability to satisfy company's outstanding financial obligations; while legal *insolvency* – serves as a legal ground for initiating bankruptcy proceedings. For further information please see Kavalnė *et al*. (2009).

initiation of insolvency proceedings in respect to the company and imposition of liability for such breach of obligations thereof, seeking to protect rights and legal interests of company's creditors (Bayer *et al.*, 2009). In Germany, if directors do not submit timely notice regarding initiating of insolvency proceedings, the "*old creditors*" (ge. '*die alten Gläubiger'*) (i.e. those, who still were the company's creditors before the company's financial difficulties) have a right to demand losses because of the increase of extent of their claim incurred due to such delay (ge. *Quotenschaden*), while the "*new creditors*" (ge. '*die neuen Gläubiger')* have a right to demand compensations due to circumstances that respective timely notice for initiating bankruptcy proceedings would prevent them from entering into respective contract with a company (ge. *negatives Interesse*) (Loos, 2006). Scientists remain at the opinion that director should be imposed certain liability for a breach of his duty to timely initiate insolvency proceedings against the company, if director's fault in a form of negligence is proven (Ulmer, Habersack and Winter, 2008). It is being argued that lack of competency or negligence cannot be considered as justifiable reason for committing such default (Schmidt, 2010). Due to applicability of such doctrine, director may avoid liability only in such case if he timely submits respective application for initiating insolvency proceedings against the company. This duty in its sense is very strict and obliges directors to monitor company's business activities and financial situation therein; as well it encourages directors to enforce available measures, when any financial difficulties are being observed. Thus, the basis for such doctrine is not a submission of an application for initiating insolvency proceedings, but implementation of so called 'going concern principle', i.e. constant assessment of company's financial status, inspection and supervision thereof, in order to, as earlier as possible, observe any symptoms of upcoming crisis and enforce efficient preventive measures for rectifying such situation and avoiding insolvency proceedings within a company (Veil, 2006). Such duty for initiating insolvency proceedings arises, when based on the company's financial statements; it is observed that the company is not capable to accumulate sufficient cash flows required for settlement of their payment obligations (Schillig, 2010). This approach is being supported by the fact that a director may be also equally liable for a breach of his fiduciary duty if such application has been submitted too early (Bayer *et al.*, 2009). This liability may be also imposed thereupon if such director has all relevant knowledge on company's economical and financial status, but he expects that the company still be capable to further carry out its business activities (Bayer *et al.*, 2009). Thus, this doctrine is based on the implementation of procedures required for receipt of an adequate business information and decision-making.

This doctrine was criticized, at first, for reasons that stipulating such liability for respective default in respect to initiating insolvency proceedings in a timely manner, creditors' legal interests are only indirectly protected, due to the fact that in such case company's but not creditors' assets are defended, as well as, in the event of breach by the director to timely initiate insolvency proceedings, only the company itself acquires the legal right to file a lawsuits against its directors, aimed at demanding compensation of losses incurred as a result of such default (Altmeppen and Wilhelm, 1999). Moreover, critics emphasizes, that such strict duty to submit application on initiating insolvency proceedings means that even certain promising business activities might get liquidated (Schillig, 2010). They do emphasize that the same purpose might be achieved by enforcing other legal measures, for instance, stipulating common duty, obliging directors to enforce all legal actions, seeking to minimize losses of company's creditors, if there are no reasonable perspectives for continuance of the company's business activities; company's creditors can be also protected by statutory restrictions, preventing embezzlement of corporate assets in the event company has financial problems (Schillig, 2010). Finally, critics have doubts with regard to efficiency of implementation of such duty, as in practice it is rather difficult to observe a moment, when company becomes insolvent and its director incurs such liability to apply to court on the initiation of insolvency proceedings. In each case it depends on subjective assessments and prognostic estimates that are not easily being determined *ex post* (Schall, 2009).

Doctrine of 'deepening insolvency' is new and still developing doctrine, which in the end of XX century was firstly elaborated and used by U.S. courts (Colasacco, 2009). Primarily, it was based on the fact that not only directors but also managers of lower level, such as legal and financial advisors, auditors, insurers and creditors should be also held responsible for the continuance of company's activities, when receiving or granting any additional loans thereto and, subsequently, increasing the amount of the company's losses (Schillig, 2010). One of the first cases, where doctrine of '*deepening insolvency*' has been introduced and applied is the case *In re Investors Funding Corporation of New York Securities Litigation*, where New York Municipal Court stated that continuance of the company's activities when certain circumstances have occurred might be detrimental to the company. Term '*deepening insolvency*' has been firstly used in case *Schacht v Brown*, where the court has resolved, that continuance of the company's activities, upon undertaking supplementary debt obligations is always considered harmful to the company. In case *Official Committee of Unsecured Creditors v Lafferty,* the court stated that even in situation, when the company's debt exceeds the real market value of its assets, the respective

capital thereof might have certain value and such fraudulent and hidden debt undertaking might be detrimental thereupon. Later on, courts have expanded such term '*deepening insolvency*'; upon determining that such liability might be imposed not only due to 'fraudulent' but also as a result of certain 'negligent' behavior. In case *In re LTV Steel Company, Inc.* it has been resolved that defendant might incur liability for '*deepening insolvency*', when based on his actions the company's activities are being continued in a fraudulent or negligent manner, subsequently resulting in increase of company's debts and creditors' losses. Moreover, it is emphasized, that such amount of reimbursable losses might be calculated based on the extent of increased undertakings, reduction of real market value of company's assets and amount of the company's lost profit (*Thabault v Chait*, 2008). Furthermore it is stated, that such supplemental debt undertakings, incurred after the company became insolvent, might be also attributed to the company's losses (*In re Flagship Healthcare, Inc.*, 2001).

Critics of '*deepening insolvency*' doctrine state that such doctrine could be considered excessive, due to the fact that for imposition thereof it is required to undertake fraudulent and hidden actions, while in the legal system it is already known and foreseen respective possibilities to file lawsuits for fraud and manipulations with securities (Thompson, 2007). Moreover, it is argued that such doctrine overall contradicts to the main principles of the company law as it opposes to the business judgement rule (Thompson, 2007). M. Schillig states, that pursuant to the business judgement rule, directors could only be exempted from the civil liability when they adopt decisions being extensively informed, acting in a due manner and reasonably believing that this decision complies with the best interests of the company (Schillig, 2010). Pursuant to this author, when a company is in state of insolvency or near becoming insolvent, and its directors are fully informed that their adopted decisions might be harmful to the company, in such event if they do not submit application for the initiating of insolvency proceedings, they should be imposed the relevant civil liability. The company's directors are not allowed 'to close their eyes' on the occurred situation that should be obvious to the reasonable director who must realistically assess the real consequences of his actions or inactivity (Cieri, Ganske and Lennox, 1999). This approach is followed in case practice of Delaware courts, where in many cases it has been resolved that if the board of directors of such insolvent company implements certain business strategy believing that it will cause an increase of the company's value, although as a result thereof the company incurs its further losses, directors will be exempted from the applicable civil liability thereupon by applying the business judgement rule (*Trenwick America Litigation Trust v. Billett*, 2007). *Vice versa*, it could be assumed that the damage caused to the

company, declining respective opportunities to fight for the company's further existence, or delaying application of the appropriate actions, seeking to assist the company, might cause event more loss, unless such actions could mean embezzlement of the company's assets (*In re Parmalat Securities Litigation*, 2007). However, Delaware courts do consider such '*deepening insolvency*' doctrine as a doctrine for compensation of losses in the event of breach of fiduciary duties (*In re The Brown Schools*, 2008; etc.). Moreover, the court in case *Thabault v Chait* has emphasized that any increase of liabilities shall be deemed harmful to the company, moreover, claimants are given sufficient legal measures for proving causality between such negligent director's actions and company's incurred damage. In reference to the fact that Delaware law has a great impact on U.S. legal system, some authors state that such Delaware approach in respect to '*deepening insolvency*' doctrine might result in withdrawal of this doctrine in other USA States (Harner and Brighton, 2008).

In Lithuanian legal system, same as in Germany dominates a doctrine of 'liability for delaying insolvency proceedings', which is recognized both in the laws and in court practise (for example, Resolution of Supreme Court of Lithuania adopted in civil case No. 3K-3-496/2013, 2013). In Article 8(1) of the Enterprise Bankruptcy Law of the Republic of Lithuania (the "Enterprise Bankruptcy Law") it is foreseen an obligation of the company's owner and director to submit application to the court regarding initiating of bankruptcy proceedings, when the following circumstances occur: (i) a company is or will not be able to satisfy claims of creditor (creditors) and he (they) did not themselves apply to the court with a bankruptcy claim or (ii) a company publicly announced or otherwise informed the creditor (creditors) that it is not able or does not intend to settle its payment obligations thereto. Part 4 of the same Article of the Enterprise Bankruptcy Law mandatory provides that the company's manager or other person authorized to adopt the respective decision on behalf of a company, must compensate losses which creditors suffered due to such company's delay to submit application for initiating bankruptcy proceedings. Although this provision has entered into force only as of 1 July 2008, the Supreme Court of Lithuania has already resolved even before that date, i.e. when either version of the Enterprise Bankruptcy Law has been in force, that the company's director has a duty to compensate creditors' losses (although that is not directly stipulated under the law) (Resolution adopted in civil case No. 3K-3-228/2011, 2011). Therefore, doctrine of 'liability for delaying insolvency proceedings' in Lithuania was enforced since the Enterprise Bankruptcy Law was enacted, i. e. since 20 March 2001. In Lithuania, same as in Germany and other states, where such doctrine is applied (for instance, Austria, Switzerland, France and others (Kraakman *et al.*, 2009)), creditors are not entitled to directly, i.e.

in their own name, submitting to the court a lawsuit against the head of the company for reimbursement of their incurred losses, as it is held that such rights are granted only to the bankruptcy administrator, in charge of defending all company's creditors interests (Article 11(3)(14) of the Enterprise Bankruptcy Law), along with the interest of the bankrupt company (Resolution of the Supreme Court of Lithuania adopted in civil case No. 3K-3-130/2011). Upon awarding reimbursement of damages in favor of the company, all received amounts shall be used *pro rata* to satisfy claims of all approved creditors, respecting the order and terms for satisfaction of creditors' claims as specified in Article 35 of the Enterprise Bankruptcy Law. The appropriate creditor might apply to the court for compensation of damages only by *indirect claim* (Article 6.68 of the Civil Code), initiating lawsuit in the name of the bankrupt company if such company (its administrator) would not enforce such right to claim damage compensation. In such case, upon satisfying the aforementioned indirect lawsuit, all demanded assets would get offset against the property of the bankrupt company and used for satisfying all creditor claims (Article 6.68(5) of the Civil Code).

In a legal doctrine it is recognized that timely submission before the court and further not delayed bankruptcy proceedings should protect creditors' rights and at least partly compensate their damages suffered due to unsatisfied undertakings from the bankrupt company's assets, therefore, such application submitted in timely manner should be a standard of due behavior by the company's owner or director in the situation of imminent bankruptcy (Kavalnė *et al.*, 2009). Although it must be taken into account that even in the applicable Enterprise Bankruptcy Law such imminent insolvency is not *expressis verbis* determined as a basis of initiating bankruptcy proceedings, but implications of such regulation must be noticed as this law explicitly provides that the head of a company must apply to the court with a bankruptcy claim against the company not only when a company is not able to settle payments towards the creditors, but also, when it is obvious, that it will not be capable to do so in the future. Scientists define '*imminent insolvency*' as a status when a debtor is able to satisfy its current obligations, but it will not be possibly capable to satisfy present or future undertakings, after they become due (Kavalnė and Norkus, 2011). Thus, an imminent insolvency from a present insolvency differs by only fact that not present but future situation that will occur when payment obligations become due is being assessed. However, the scientists argue that due the fact that the law does not provide neither the term of the imminent insolvency, nor criteria for determination of such status, then, in the event of failure to apply to the court for initiating of bankruptcy proceedings against the company by the owner or director thereof in case of possible imminent insolvency would not imply

any breach of statutory requirements (Kavalnė and Norkus, 2011). We do not agree with such approach, as the law explicitly stipulates a duty to apply to the court, when it is obvious that in the future a company will not be able to settle up with the creditors, however, we agree that the law must clearly determine the definition of an imminent insolvency, as well as criteria for its assessment.

Personal Liability of Directors after Company's Liquidation

Although the Supreme Court of Lithuania has determined a common rule that a civil liability of directors might be imposed against both: a company, when a director is acting against interests of a company, and a third party, when a director is acting in breach of limitations, granted by certain warranties issued for the benefit of such third party (Resolution adopted in civil case No. 3K-7-266/2006, 2006), however, this rule can be further explicated upon distinguishing three steps, visualized in Table 1 hereunder.

Table 1. The Limits of Limited Liability for Company Directors

	Company is solvent	Company is insolvent	Company is liquidated
Personal liability	against company	against company	against creditors
Company's action	direct (submitted by shareholders - so-called "*derivative action*")	direct (submitted by bankruptcy administrator)	–
Creditor's action	indirect	indirect	direct

As it can be noticed from the Table 1 hereinabove, the company's directors are entitled to the limited liability defense, unless due to their unjust actions it has been caused any damage to the company or a respective third party. However, the direct liability against the third parties is possible only after the completion of the company's liquidation procedures, as the third parties are entitled only to the indirect lawsuit in the name of a company. This is repeatedly stated by the Supreme Court of Lithuania, emphasizing that following the opening of a bankruptcy proceedings against the defendant (company), then the respective creditor's claims are not satisfied thereunder, the right to submit claim for compensation of losses against the natural persons that have been comprising management bodies of the bankrupt company remains even after the bankruptcy proceedings are completed,

respectively, the court will have to decide, whether there are conditions for civil liability against the defendant of such claim (Resolutions adopted in civil cases No. 3K-3-19/2012, 2012 and No. 3K-3-234/2013, 2013). At the same time the court has emphasized, that retaining of such right to file a claim against the company's director that is responsible for incurred losses after the company is liquidated due to its bankruptcy, shall mean protection of creditor's legal interests, real existence of creditor's subjective rights and practical implementation thereof. Former members of the bankrupt company's management bodies may be held liable for caused damages, incurred due to the company's failure to fulfill obligations towards the creditors, when it is proven that they personally or through exercising their decision right has adopted respective business decisions that did not comply to the ordinary business practice and/or contradicts to the requirements stipulated at law or company's incorporation documents which had caused the company's insolvency, and as a result thereof the company was not able to settle up with its creditors. Civil liability of persons that comprised respective management bodies of liquidated bankrupt company may be imposed not only in cases, when company's capacity to fulfill contractual undertakings towards its creditors has been caused by the unlawful actions thereof that were determined as criminal acts under conviction documents (such as criminal charges, penal injunction), but also in cases, when a company's insolvency and inability to fulfill payment obligations towards the creditors was a direct consequence of certain actions carried out by individuals comprising the company's management bodies, provided certain liability conditions are being established (Resolution adopted in civil case No. 3K-3-214/2011, 2011).

Conclusion

The analysis provided in this article has shown that limited liability doctrine shall be applicable not only in respect to shareholders of a company, but also towards directors thereof.

It was emphasised that limited liability defense shall be applicable on the directors in respect to both – contractual and tortious liability. However, such legal protection from the liability could be withdrawn, when a director commits illegal acts that cause damages to a company or to creditors thereof. In respect of creditors the liability of such director shall still be considered subsidiary, whereas a direct liability of the director may only arise against a company until its liquidation and only after the completion of liquidation proceedings – against the creditors whose claims remained unsatisfied.

References:

Altmeppen, H.; Wilhelm, J. (1999), "Quotenschaden, Individualschaden und Klagebefugnis bei der Verschleppung des Insolvenzverfahrens über das Vermögen der GmbH", *Neue Juristische Wochenschrift*, Vol. 52, pp. 673-681.

Anderson, H. (2004), "The Theory of the Corporation and its Relevance to Directors' Tortious Liability to Creditors", *Australian Journal of Corporate Law*, Vol. 16, pp. 73-95.

Bayer, W., *et al*. (2009), *Lutter. Hommelhoff. GmbH-Gesetz. 17 Auflage*, Dr. Otto Schmidt, Köln.

Baxter, C. (1995), "Demystifying D&O Insurance", *Oxford Journal of Legal Studies*, Vol. 15 No. 4, pp. 537-564.

Cheffins, B. R. (2002), "Corporate Law and Ownership Structure – A Darwinian Link?", *University of New South Wales Law Journal*, Vol. 25 No. 2, pp. 346-378.

Cieri, R. M.; Ganske, L. G.; Lennox, H. (1999), "Breaking Up is hard to do: Avoiding the Solvency-related Pitfalls in Spinoff Transactions", *Business Lawyer*, Vol. 54 No. 2, pp. 533-605.

Colasacco, L. (2009), "Where were the Accountants? Deeping Insolvency as a Means of Ensuring Accountants' Presence when Corporate Turmoil Materializes", *Fordham Law Review*, Vol. 78, pp. 793-861.

Davies, L. P. (2002), *Introduction to Company Law*, Oxford University Press, New York.

Didžiulis, L. (2008), Bendrovės vadovų civilinė atsakomybė kreditoriams [Civil Liability of Company's Directors Towards the Creditors], *Justitia*, Vol. 3 No. 69, pp. 53-65.

Doyle, L. (2010), "The Susceptibility to Meaningful Attack of Breaches of Directors' Duties under English Law", available at: http://www.law.leeds.ac.uk/assets/files/research/events/directors-duties/doyle-susceptibility-to-meaningful-attack.pdf (accessed 4 May 2014).

Finch, V. (2002), *Corporate Insolvency Law: perspectives and principles*, Cambridge University Press, Cambridge.

Glynn, T. P. (2004), "Beyond 'Unlimiting' Shareholder Liability: Vicarious Tort Liability for Corporate Officers", *Vanderbilt Law Review*, Vol. 57, pp. 329-433.

Grantham, R. B. (2007), "The Limited Liability Of Company Directors", Research Paper, TC Beirne School of Law, The University of Queensland, Queensland, Australia, 3 July.

Griffin, S. M. (1999), *Personal Liability and Disqualification of Company Directors*, Hart Publishing, Oxford.

Harner, M. M.; Brighton, J. A. J. (2008), *The Implications of North American Catholic and Trenwick: Final Death Knell for Deepening*

Insolvency? Shift in Directors' Duties in the Zone of Insolvency? Annual Survey of Bankruptcy Law, West Publishing Company, Sent Paul Minnesota.
Hedley Byrne & Co Ltd v. Heller & Partners [1964] AC 465.
Lacobucci, E. M. (2001), "Unfinished Business: An Analysis of Stones Unturned in ADGA Systems International v Valcom Ltd", *Canadian Business Law Journal*, Vol. 35 No. 1, pp. 39-54.
In re Flagship Healthcare, Inc., 269 B.R. 721 (Bkrtcy, S.D. Fla., 2001).
In re Investors Funding Corporation of New York Securities Litigation (Bloor v. Dansker), 523 F. Supp. 533 (S.D.N.Y., 1980).
In re LTV Steel Company, Inc., 333 B.R. 397 (Bkrtcy, N.D. Ohio, 2005).
In re Parmalat Securities Litigation, 501 F.Supp.2d 560, 576 (S.D.N.Y., 2007).
In re The Brown Schools, 386 B.R. 37, 48 (bkrtcy. D. Del., 2008).
Kahn-Freund, O. (1994), "Some Reflections on Company Law Reform", *The Modern Law Review*, Vol. 7, pp. 54–66.
Kavalnė, S., *et al*. (2009), *Bankroto teisė. Pirmoji knyga. Vadovėlis* [Bankruptcy Law. First Book. Textbook], Justitia, Vilnius.
Kavalnė, S.; Norkus, R. (2011), *Bankroto teisė. Antroji dalis. Vadovėlis* [Bankruptcy Law. Second Part. Textbook], Justitia, Vilnius.
Kraakman, R. R., *et al*. (2009), *The Anatomy of Corporate Law. A Comparative and Functional Approach*, Oxford University Press, Oxford.
Lietuvos Respublikos įmonių bankroto įstatymas [Enterprise Bankruptcy Law of the Republic of Lithuania] (2001), *Valstybės žinios*, No. 31-1010.
Loos, A. (2006), "Germany", in Loos, A (Ed.), *Director's Liability: A Worldwide Review*, Kluwer Law International, Netherlands, pp. 283-291.
Lutter, M.; Hommelhof, P. (2000), *GmbH Gesetz: Kommentar. 15 Auflage*, Dr Otto Schmidt, Köln.
Mendelson, N. A. (2002), "A Control-based Approach to Shareholder Liability for Corporate Torts", *Columbia Law Review*, Vol. 102, pp. 1203-1303.
Nieuwdorp, R; Roeck De M. (2006), Belgium, in Loos, A (Ed.), *Director's Liability: A Worldwide Review*, Kluwer Law International, Netherlands, pp. 225-237.
Official Committee of Unsecured Creditors v Lafferty & Co., Inc., 267 F.3d 340 (C.A. 3 (PA), 2001).
Re Supply of Ready Mix Concrete (No 2) [1995] 1 AC 456
Reynolds, F. M. B. (2006), *Bowstead and Reynolds on Agency*, Sweet & Maxwell Ltd, London.
Revenue and Customs Comrs v Benton-Diggin [2006] All ER (D) 264 (Feb), ChD.
Resolution of the Supreme Court of Lithuania as of 25 May 2006 adopted in civil case *K. J. J. v. V. K. ir J. B.* (case No. 3K-7-266/2006).

Resolution of the Supreme Court of Lithuania as of 3 June 2008 adopted in civil case *UAB "Naujapilė" v. Republic of Lithuania* (case No. 3K-3-295/2008).
Resolution of the Supreme Court of Lithuania as of 25 March 2011 adopted in civil case *BUAB "Limantra' v. N. G.* (case No. 3k-3-130/2011).
Resolution of the Supreme Court of Lithuania as of 29 April 2011 adopted in civil case *Vilnius District Chief Prosecutor and UAB "Vilniaus vandenys" v. A. J. V. M. and B. J. B.* (case No. 3K-3-214/2011).
Resolution of the Supreme Court of Lithuania as of 5 May 2011 adopted in civil case *BUAB "Vajalio medienos gaminiai" v. R. K. ir N. K.* (case No. 3K-3-228/2011).
Resolution of the Supreme Court of Lithuania as of 1 February 2012 adopted in civil case *UAB "Panevėžio spaustuvė" v. R. S., A. B. and A. G.* (case No. 3K-3-19/2012).
Resolution of the Supreme Court of Lithuania as of 19 April 2013 adopted in civil case *UAB "GlaxoSmithKline Lietuva" v. D. B., K. B., L. K., M. V. and G. A.* (case No. 3K-3-234/2013).
Resolution of the Supreme Court of Lithuania as of 17 May 2013 adopted in civil case *AB "Klaipėdos Smeltė" v. L. A.* (case No. 3K-3-290/2013).
Resolution of the Supreme Court of Lithuania as of 16 October 2013 adopted in civil case *BUAB "AK baldai" v. E. G., A. Š., K. Š. and T. Š.* (case No. 3K-3-496/2013).
Resolution of the Supreme Court of Lithuania as of 20 November 2013 adopted in civil case *UAB "Toris" v. J. S. and UAB "Dajuma"* (case No. 3K-3-581/2013).
Ribstein, E. L. (2002), "Markets vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002", *Journal of Corporation Law*, Vol. 28, pp. 1-74.
Schacht v Brow, 711 F.2d 1343 (C.A. Ill., 1983).
Schall, A. (2009), *Kapitalgesellschaftsrechtlicher Gläubigerschutz*, C. H. Beck, München.
Schillig, M. (2009), "Deepening Insolvency – Liability for Wrongful Trading in the United States?", *Company Lawyer*, Vol. 30, pp. 298-301.
Schillig, M. (2010), "The Transition from Corporate Governance to Bankruptcy Governance – Convergence of German and US law?", *European Company and Financial Law Review*, Vol. 7 No. 1, pp. 116-157.
Schmidt, K. (2010), *Scholz. GmbH-Gesetz. 10 Auflage*, Dr. Otto Schmidt, Köln.
Spender, P. (2005), "Weapons of Mass Dispassion: James Hardie and Corporate Law", *Griffith Law Review*, Vol. 14 No. 2, pp. 280-294.
Static Control Components (Europe) Limited v Egan (2004) ALL ER(D) 4.
Thabault v Chait, 541 F.3d 512, 522 (3rd Cir. 2008).

Thompson, D. C. (2007), "A Critique of 'Deepening Insolvency'. A New Bankruptcy Tort Theory", *Stanford Journal of Law, Business & Finance*, Vol. 12, pp. 536-567.

Tikniūtė, A. (2006), "*Juridinio asmens ribotos atsakomybės problema: teisiniai aspektai* [Problem of Legal Entity's Limited Liability: Legal Aspects]", *Doctoral Thesis*, Mykolas Romeris University, Vilnius.

Trenwick America Litigation Trust v. Billett, 931 A.2d 438 (Del.Supr., 2007).

Trevor Ivory Ltd v Anderson [1992] 2 NZLR 517.

Ulmer, P.; Habersack, M.; Winter, M. (2008), *Gesetz betreffend die Gesellschaften mit beschränkter Haftung: GmbH. Großkommentar. Band III*, Mohr Siebeck, Tübingen.

Veil, R. (2006), "Krisenbewältigung durch Gesellschaftsrecht – Verlust des halben Kapitals, Pflicht zu ordnungsgemäßer Liquidation und Unterkapitalisierung", *Zeitschrift für Unternehmens- und Gesellschaftsrecht*, Vol. 35 No. 07, pp. 378-380.

Williams v. Natural Life Health Foods Ltd [1997] 1 BCLC 131 (CA) and [1998] 2 All ER 577 (HL).