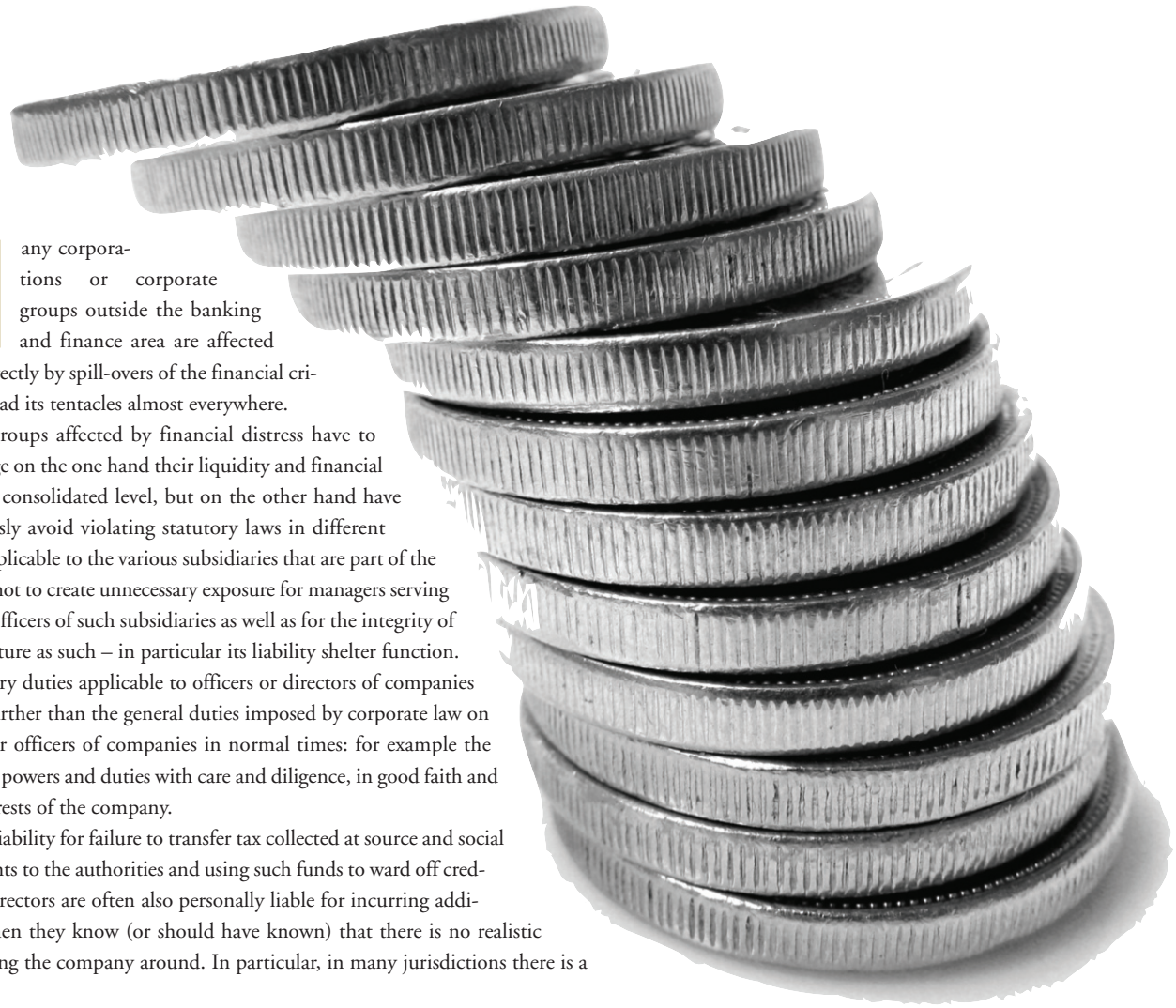
A BALANCING ACT

Alexander Vogel, **Daniel Schoch** and **Debora Kern** of **meyerlustenberger** discuss the range of liabilities on de facto directors and officers under Swiss law



Many corporations or corporate groups outside the banking and finance area are affected directly or indirectly by spill-overs of the financial crisis that has spread its tentacles almost everywhere.

Corporate groups affected by financial distress have to carefully manage on the one hand their liquidity and financial covenants on a consolidated level, but on the other hand have to simultaneously avoid violating statutory laws in different jurisdictions applicable to the various subsidiaries that are part of the group in order not to create unnecessary exposure for managers serving as directors or officers of such subsidiaries as well as for the integrity of the group structure as such – in particular its liability shelter function.

Such statutory duties applicable to officers or directors of companies in distress go further than the general duties imposed by corporate law on directors and/or officers of companies in normal times: for example the duty to exercise powers and duties with care and diligence, in good faith and in the best interests of the company.

Apart from liability for failure to transfer tax collected at source and social security payments to the authorities and using such funds to ward off creditors instead, directors are often also personally liable for incurring additional debts when they know (or should have known) that there is no realistic chance of turning the company around. In particular, in many jurisdictions there is a

risk for directors of such subsidiaries for delaying necessary restructuring measures or the initiation of insolvency proceedings. According to Swiss law, the duty to file for insolvency proceedings kicks in if the company has lost its entire equity and, thus, its aggregate debts exceed its aggregate assets or if it is unable to pay its debts as they fall due. In Switzerland as well as in many other jurisdictions, further rules prohibit formal as well as *de facto* directors from prejudicing creditors in distress situations, by preferential transfers to other group companies, for example.

In addition to the individuals serving as (formal) directors or officers of such subsidiaries in Switzerland, the parent company itself can also qualify as *de facto* director or officer of a subsidiary and, thus, be subject to particular duties, and in case of their violation, to liability.

In Switzerland, the meaning and consequences of being a *de facto* director becomes particularly relevant when a person is made defendant in a procedure regarding the liability for acts or omissions as a director of the board of a corporation (*Aktiengesellschaften*) or a limited liability company pursuant to art. 754, para. 1 of the Swiss Code of Obligations (SCO) for alleged breaches of duties committed.

Prerequisites for directors and officers liability

The legal basis for D&O liability under Swiss law is found in art. 754 para. 1 SCO. It provides the following:

"The members of the board of directors and all persons engaged in the management or liquidation of the company are liable both to the company and to the individual shareholders and creditors for any losses or damage arising from any intentional or negligent breach of their duties."

Under Swiss law, the individuals and legal entities that are subject to D&O liability pursuant to this provision are determined based on a functional approach: besides the individuals that serve as board members (directors in the formal sense), all persons engaged in the management of the company are subjected to D&O liability. Thus, directors in the formal sense, as well as the following three categories of persons that determine the decision-making process of the company, are subject to D&O liability.

The first category is persons performing management functions based on internal organisational regulations, appointment or delegation of functions, in particular, a delegation or a mandate to represent the company other than only in a limited subject matter, namely officers, COOs, CFOs, and so on (classed here as directors/officers in the material sense; Decision of the Swiss Federal Supreme Court of December 12 1991, ATF 117 II 570, p. 573, consid. 3).

The second category is persons executing management functions that are not based on internal organisation appointment or delegation such as major shareholders or banks (classed here as *de facto* directors or officers; Decision of the Swiss Federal Supreme Court of February 8 2010, 4A_306/2009, consid. 7.1.1).

The third category is persons acting in a way that induces third parties to conclude in conformity with the principle of good faith, and contrary to the real facts, that they are directors or officers in the formal or material sense of the company (in other words apparent directors or officers; Decision of the Swiss Federal Supreme Court of December 12 1991, ATF 117 II 570, p. 572 *et seq.*, consid. 3, *obiter dictum*).

There are several prerequisites for D&O liability: (i) a breach of duty set out by law, the articles of association, organisational regulations or other internal directives; (ii) a fault of the director or officer: wilful or negligent (lack of due diligence) behaviour of the director or officer; (iii) a damage suffered by the claimant or the company: an involuntary

> **"Directors are often also personally liable for incurring additional debts when they know that there is no realistic chance of turning the company around"**

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diminution of the company's and/or shareholders' or creditors' net assets or missed profit; and (iv) an adequate causal connection between the breach of duty and the damage: connections that are unexpected or of a remote nature are not sufficient (Decision of the Swiss Federal Supreme Court of June 27 2006, ATF 132 III 564, p. 572, consid. 4.2).

The duties of care that may give rise to D&O liability are dispersed all over the Swiss legal system, particularly corporate law, criminal law, insolvency law, tax law, old age insurance law, anti-trust law, health and safety law, environmental law, and labour law.

D&O liability of corporate bodies exists not only with respect to the company itself, but, under certain conditions also, with respect to its shareholders and creditors. To determine a shareholder's right to sue, it has to be differentiated (Decision of the Swiss Federal Supreme Court of November 9 2004, ATF 131 III 306, p. 310, consid. 3.1.1) particularly, whether the shareholder suffered a personal financial loss (direct damage), for example non-payment of legitimate dividends due to a breach of duty of the director or officer, or an indirect loss which is derived from the damage suffered by the company (indirect damage), for example diminishment of the value of the shares. In case of a direct damage, shareholders may claim performance to themselves from corporate bodies at any time, whereas in the case of an indirect damage the claim of the individual shareholder is exclusively for performance to the company (ibid.; art. 756 para. I SCO).

When determining the creditor's right to sue, apart from the distinction between indirect or direct damage, it also has to be differentiated whether the company is solvent or insolvent. Creditors have no possibility of claiming indirect damage when the company is still solvent (ibid.). The creditors can only demand performance for any indirect damage suffered on behalf of the company, when the company is insolvent. This possibility is restricted insofar as the liquidator has priority – the creditor can claim damages only when the liquidator waives to claim damages (ibid.; art. 757 para. I SCO).

When the creditors or shareholders suffer a direct damage, they can make claims against the directors or officers without any restrictions when the company is solvent. However, as soon as the company becomes insolvent the claims of the creditors and shareholders are in competition with the claims of the company against its directors – that is, the liquidator.

Thus, the Swiss Federal Court has restricted the possibility for creditors and shareholders to make claims for direct damage when the company is insolvent. Creditors as well as shareholders can only make claims when (i) the actions of the director or officer contravene stock corporation regulations which solely aim at protecting creditors or shareholders; (ii) the liability for damages arises out of an illegal conduct of the director or officer based on art. 41 SCO; or (iii) it arises out of *culpa in contrahendo* (ibid., consid. 3.1.2).

Limitations of D&O liability

The members of the board of directors can limit their liability by transferring responsibilities to others to the extent permissible by law. Responsibilities may particularly be transferred to committees and delegates within the board of directors, to officers and with regard to the preparation of decisions

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> **A qualification as a de facto director may have far-reaching implications**

(the gathering of information, preparation of documents or evaluation of alternatives), to employees or external advisers. Limitation of liability is, however, subject to the prerequisites that the by-laws and the business rules provide for a right to delegate the respective task and that the delegate had been duly selected, instructed and supervised (art. 754 para. 2 SCO).

Further, the shareholders' meeting has the inalienable duty to discharge directors from personal liability each year (art. 698 para. 2 subpara. 5 SCO). This resolution is only effective for disclosed facts and only as against the company and those shareholders who approved the resolution or who have, since the resolution was passed, acquired their shares in full knowledge of the resolution (art. 758 para. 1 SCO).

To avoid forfeiture of their claims, in case of an indirect damage, the eligible shareholders, particularly the non-consenting and abstaining shareholders, have to file a liability suit within six months from the date of such resolution of release (art. 758 para. 2 SCO). This limitation does not, however, apply with respect to creditors as they are not involved in the granting of discharge.

Liability within group companies

Under Swiss law there is, except for provisions that are not of interest for the issues discussed here, no specific body of law applicable to groups of companies or affiliated companies. Rather than considering the corporate group as an unitary economic enterprise (single enterprise approach), Swiss law, for various reasons, strictly follows the separate legal entity approach.

Therefore, each company in a corporate group is considered as a separate legal entity which has to be looked at individually (Decision of the Swiss Federal Supreme Court of April 5 1984, ATF 110 Ib 127, p. 132, consid. 3.b.bb); the corporate bodies of each subsidiary must, thus, duly safeguard the interests of the company and particularly, even in the presence of a corporate group, not contravene the interests of the respective group company in an arbitrary and severe manner (Decision of the Swiss Federal Supreme Court of January 9 2004, ATF 130 III 213, p. 219, consid. 2.2.2).

As a result of the principle described above, D&O liability of a group company's corporate bodies is exclusively limited to acts and omissions committed in their capacity as corporate bodies of this respective group company according to Swiss law. Thus, acts and omissions committed by the corporate bodies of other group companies or by persons who are corporate bodies of several group companies simultaneously (*Doppelorgane*; Decision of the Swiss Federal Supreme Court of February 8 2010, 4A_306/2009, consid. 7.1.2), or acts and omissions committed in the capacity as corporate bodies of another group company, do not fall under D&O liability of that respective group company.

The corporate bodies of a parent company thus, cannot be made defendant in a trial on D&O liability initiated by the shareholders of the parent company for acts and omissions committed either by the subsidiary's corporate bodies or, committed by themselves, as *Doppelorgane*, but exclusively in their capacity as corporate bodies of the subsidiary. If the parent company were to influence the *Doppelorgan* directly through instructions, however, the parent company – and its respective directors and officers – could be *de facto* directors and, thus, liable according to art. 754 SCO (Decision of the Swiss Federal Supreme Court of February 8 2010, 4A_306/2009, consid. 7.1.2).

De facto directors

It results from the functional concept of directors or officers provided for by art. 754 para. 1 SCO and particularly the case law cited above that persons other than directors or officers in the formal sense may, under exceptional circumstances, become subject to D&O liability. Though not formally appointed to the board, these other persons, in particular, directors or officers in the material sense, *de facto* directors or officers, may become subject to D&O liability. Therefore, the question arises what requirements a person must fulfil, i.e. what actions by the respective person are necessary, to qualify as a *de facto* director.

De facto directors are persons that are involved in the management of a company, but have neither been appointed nor elected for such a position, nor has the management of a company been delegated to the respective person. Thus, the person usurps the management functions.

According to the Swiss Federal Supreme Court, *de facto* directors are persons who take decisions which are in general reserved to the directors in the formal or material sense or they execute management functions and, thus, take part in the decision making of the company (Decision of the Swiss Federal Supreme Court of May 4 2006, ATF 132 III 523, p. 528 *et seq.*). It is irrelevant whether the person influences the decision making directly, by means of an actual contribution to the decision making, or indirectly, by means of influencing a person, who is entitled to take the decision. For the person to be considered as a *de facto* director, it is essential that he/she can manage the company independently and autonomously.

A *de facto* director does not lie at hand, when the person merely assists in taking decisions (Decision of the Swiss Federal Supreme Court of February 8 2010,

4A_306/2009, consid. 7.1.1; Decision of the Swiss Federal Supreme Court of November 9 2009, ATF 136 III 14, p. 20 *et seq.*, consid. 2.4). In all cases it is necessary, but insufficient on its own, that the person acting as a body of a company is capable of preventing the occurrence of the damage (Decision of the Swiss Federal Supreme Court of October 29 2001, ATF 128 III 29, p. 30, consid. 3.a; Decision of the Swiss Federal Supreme Court of September 10 1985, ATF 111 II 480, p. 484).

The status as a *de facto* director requires that the person has permanent authority. The person needs to have the competence to take decisions that go beyond the regular day-to-day business and these decisions need to be taken on their own responsibility. Thus, one or two separate isolated actions are insufficient (Decision of the Swiss Federal Supreme Court of November 9 2009, ATF 136 III 14, p. 20 *et seq.*, consid. 2.4; Decision of the Swiss Federal Supreme Court of October 29 2001, ATF 128 III 29, p. 30, consid. 3.a and p. 33, consid. 3.c).

In particular cases it could be possible, however, that a single, far-reaching interference could lead to a person being classified as a *de facto* director. In such a case the D&O liability should be restricted to the respective interference. The Swiss Federal Supreme Court had to decide whether a person could be considered as a *de facto* director based on the fact that it was his responsibility to prepare and implement the resolutions passed by the directors in the formal sense. The respective person did sign the balance sheet and income statement – a task usually reserved for the managing directors – however the Swiss Federal Supreme Court stated that these activities are not sufficient to classify a person as a *de facto* director (ibid., p. 30, consid. 3.a and p. 33, consid. 3.c).

Additionally, in exceptional cases it is possible that a person is held liable as a *de facto* director for omissions. This is the case when a person presumes to take on a leading role, but omits contrary to his/her duty to carry out an action which would avert damage (ibid., consid. 3.a).

Corporate bodies can also be classified as *de facto* directors (Decision of the Swiss Federal Supreme Court of February 8 2010, 4A_306/2009, consid. 7.1.1; Decision of the Swiss Federal Supreme Court of May 4 2006, ATF 132 III 523, p. 528 *et seq.*, consid. 4.5). Thus, a parent company may be considered a *de facto* director when it gets involved in the management of the subsidiary. However, a mere involvement is insufficient.

> **De facto directors are the masterminds in the background**

A *de facto* director lies at hand when competences of the parent company with regards to the subsidiary are established which are usurped or transferred (Decision of the Swiss Federal Supreme Court of February 8 2010, 4A_306/2009, consid. 7.1.1; Decision of the Swiss Federal Supreme Court of October 29 2001, ATF 128 III 92, p. 94, consid. 3.a). As discussed above, a D&O liability of the parent company as a *de facto* director may, in particular, occur when the directors in the formal sense of the subsidiary are simultaneously the directors in the formal sense of the parent company.

A qualification as a *de facto* director may have far-reaching implications.

A person classified as a *de facto* director may be held liable in the sense of art. 754 SCO if the prerequisites laid out above are fulfilled – in particular the *de facto* director has acted negligently when exercising its usurped authority. The mere interference as such, without negligent behaviour in performing management tasks, does not lead to liability.

Further, the directors in the formal or material sense may not tolerate such actions by the *de facto* director(s); otherwise they too act negligently and can become liable.

Additionally, the Swiss Penal Code, the Swiss tax system and social security apply the concept of a *de facto* director, which may lead to further consequences for a person being qualified as a *de facto* director.

In short it can be said that *de facto* directors are those persons (corporate bodies or individuals) who are the masterminds in the background. It includes all those persons that take decisions which are reserved for the directors in the formal or material sense or persons who determine the actual management of the respective company.

Additionally, it becomes clear that being classified as a *de facto* director may have far-reaching consequences. Thus, to avoid being classified as a *de facto* director it is important to set oneself apart from tasks reserved to the directors or officers in the formal or material sense.

If the performance of management functions at the level of a subsidiary by an officer of the parent company (or the parent itself) becomes unavoidable, special attention is required to comply with all statutory duties of a director of the subsidiary in order to avoid a claim of negligent behaviour. It is also evident that each situation would have to be assessed individually before the classification as a *de facto* director, and any potential liability as a consequence thereof, can indeed be answered affirmatively.