Current News

Directors' liability in Switzerland

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On June 27, 2006, the Swiss Supreme Court (www.bger.ch) rendered a judgment relating to the liability of the members of the board of directors of a Swiss stock company (judgment n° 4C. 122/2006). The judgment, which was recently published, is interesting as it clearly outlines how third parties which have suffered financial damages in connection with the bankruptcy of a stock company can claim compensation from the directors of that company, and which conditions must be met in order to hold the directors liable for their actions.

The present memorandum summarizes this decision of the Swiss Supreme Court. One of its purposes is to give general guidance to directors with respect to their obligations when serving on boards of Swiss companies facing financial difficulties or bankruptcy. It may also be of interest to creditors of a bankrupt company who believe that they may have a claim against the directors, and who may wish to bring such a claim under Swiss law.

A. Case Facts

Briefly summarized, the facts of the case are as follows :

A Swiss stock company was incorporated in Geneva in 1983. Its shareholders were the members of a family living abroad. Two attorneys (hereafter referred to as the "Directors") were sitting on the Board of Directors of the company.

The company never had any commercial activity whatsoever. It did, however, enter into a lease agreement relating to premises in Geneva in 1984, and otherwise had expenses, such as paying its auditors and directors.

Every year since its incorporation, the company held the compulsory annual shareholders' meeting, during which the Directors were present, but not the Chairman of the Board. After the meetings, the Directors always provided the Chairman of the Board with a copy of the auditor's report and the minutes of the shareholders' meeting, and always queried what the views of the Chairman were with respect to the company, as its financial resources were constantly diminishing due to the regular payment of the company's expenses.

In 1990, the auditors of the company informed the Directors that the losses incurred by the company exceeded half of its share capital. Under Swiss law, in such a situation, the directors of the company would have had to take immediate action. The Directors, however, decided not to do so, since the company had no debt, as it was paying its expenses on a regular basis. The annual accounts were therefore approved, and the loss of the company carried forward. This situation was repeated in the next two years.

In 1992, the company ended all payments of the rent of its Geneva premises. The landlord therefore started legal proceedings against the company in August and November 1992. In February 1993, the Directors asked the company's auditors if a reserve should be made in the company's accounts in relation to the claims brought by the landlord. The auditors advised that a simple note in the accounts would be sufficient, and no reserve was made.

The Directors and the auditors of the company resigned in 1995. During the same year, the landlord, which had become bankrupt, assigned its claim against the company to a bank, which commenced proceedings, and obtained a judgment against the company for all amounts not paid under the lease agreement. However, the company also went bankrupt in 1997, and neither the bank nor the landlord's bankruptcy estate obtained any monies during the liquidation of the company.

On this basis, the bank and the landlord's bankruptcy estate were assigned the right, by the company's bankruptcy estate, to bring an action against the Directors of the company (action which was brought by the bank).

On the basis of these facts, the Swiss Supreme Court proceeded to examine three important issues in relation to claims against directors. These questions are 1)Who can bring legal proceedings against directors? 2)Which conditions must be met in order to hold directors liable and 3) If several directors are held liable, is it a case of joint liability?

B. Who can bring legal proceedings against directors?

According to the Swiss Supreme Court, and pursuant to Articles 754 ff. of the Swiss Code of Obligations, the question of who can bring legal claims against directors depends on the type of damage which has been incurred.

Three situations must be considered. Firstly, the claimant may have personally suffered a financial loss due to the actions of the directors. This situation is described as a direct damage.

Secondly, the actions of the directors may have caused the company a financial damage, the consequence of which is that the claimant may not obtain full satisfaction of its claim from the company. In practice, this case is the most frequent, and is described as indirect damage, as the damage is directly suffered by the company, and subsequently indirectly by the claimant as third party creditor of the company. As long as the company remains solvent, such damage is not felt by the third party creditor. It is only when the director's actions have brought the company to insolvency and bankruptcy that such damage crystallizes for the third party.

Thirdly, in other cases, the actions of the directors cause a direct financial damage to the third party and to the company. In such cases, both entities suffer a financial damage, but the damage suffered by the third party is not due to the bankruptcy of the company.

The possibility to bring an action against the directors depends on the type of damage suffered:

- If the third party claimant has suffered a direct damage due to the actions of the director, without the company suffering any financial damage, it may always bring an individual action against the directors, regardless of whether the company has become bankrupt or not.
- If the third party claimant has suffered an indirect damage as described above, that is, if the actions of the directors have caused a direct financial damage to the company, the consequence of which is that the third party, as a creditor of the company, will not be paid back due to the bankruptcy of the company, the claim against the directors can only be brought by the company itself. The third party has no claim against the company at this stage. If the company goes bankrupt, the claim will have to be brought by the company's bankruptcy estate. The estate may, however, decide not to exercise the claim. In that case, the third party creditor can require the estate to assign the claim to him. If the third party creditor to whom the claim has been assigned obtains a judgment against the directors, the proceeds will, in priority, go to the third party creditor, and once the third party has been fully satisfied, to the company's bankruptcy estate.
- If both the company and the third party creditor have suffered a direct financial damage due to the actions of the directors, the third party may only bring a direct claim against the directors if its claim is based on tort, on wrongful pre-contractual negotiations or on a provision of law which is exclusively intended to protect third party creditors. In this scenario, the possibility for the third party creditor to bring a direct claim against the directors has been limited by the Swiss Supreme Court, in order to avoid a risk of conflict between the claim of the company and the claim of the third party creditors.

In the case at hand, the landlord had suffered an indirect damage, as it had not been able to recover the amount which was due to it by the company under the lease agreement. The claim against the directors therefore belonged to the company's bankruptcy estate, which assigned it to the landlord's bankruptcy estate and the bank.

C. Which conditions must be met?

The Swiss Supreme Court subsequently examined the conditions which have to be met under Swiss law in order to hold Company directors liable for their actions. The conditions are:

1. A breach, by the directors, of their duties as directors;
2. A fault committed by the directors, either intentionally or by negligence;
3. A damage suffered by the company; and
4. a causal link between the breach of the director's duties and the damage suffered by the company.

The Swiss Supreme Court came to the conclusion that the conditions mentioned above were met. Indeed, the directors had not taken appropriate actions once they had knowledge that the company was suffering from financial difficulties. Their regular queries to the Chairman of the Board regarding the financial condition of the company were insufficient measures. Under Swiss law, if, according to the last year's balance sheet, half of the share capital and the legal reserves are no longer covered, the directors are obliged to call a shareholders' meeting and to propose reorganization measures. If it is likely that there is excessive indebtedness, an interim balance sheet must be prepared. If it appears that the claims of the creditors are no longer covered at going concern value or at disposal value, the directors must notify the court, unless creditors of the company in the amount of such deficiency subordinate their claims to all other creditors of the company.

Such actions were not taken by the Directors. Further, no reserve had been made in the accounts of the company in relation to the claims brought by the landlord for unpaid rent, although it clearly appeared that such a reserve was necessary.

With respect to the causal link, the Swiss Supreme Court held that any delay in notifying the Court and initiating bankruptcy proceedings generally causes the company a financial damage.

The Swiss Supreme Court therefore held the Directors liable for the entirety of the claim brought by the bank.

D. Joint liability?

With respect to the type of liability incurred by the Directors, the Swiss Supreme Court concluded that each of the Directors would have been entitled to present arguments to the Court relating to this Director's personal situation in order to diminish his liability. Indeed, Article 759 of the Swiss Code of Obligations stipulates that if a number of persons are liable for damages, each of them shall be jointly liable with the others to the extent that he is personally accountable for the damages based on his own fault and the circumstances. However, in the present case, the Court found no reasons to diminish one Director's liability with respect to the other, and the Directors were thus held jointly and severally liable.

E. Conclusion

This case is one of the few published cases in which the directors of a Swiss stock company have been held liable for their actions. It can however be assumed that such legal actions under Swiss law will increasingly be brought against directors, and that judgments such as the one described here will become more frequent. Directors should therefore be particularly cautious whenever it appears to them that the Swiss stock company on whose board they sit is facing financial difficulties. The absence of appropriate action in such circumstances may, as shown here, bear major consequences for the directors personally.