

ALLEN & OVERY

Directors' duties and liabilities in financial distress during Covid-19

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A global perspective

Uncertain times give rise to many questions

The Covid-19 pandemic and the ensuing economic crisis has a significant impact, both financial and otherwise, on companies around the world. Boards are struggling to ensure survival in the short term and preserve cash, whilst planning for the future, in a world full of uncertainties.

Many directors are uncertain about their responsibilities and the liability risks in these circumstances. They are facing questions such as:

- If the company has limited financial means, is it allowed to pay critical suppliers and leave other creditors as yet unpaid? Are there personal liability risks for 'creditor stretching'?
- Can you enter into new contracts if it is increasingly uncertain that the company will be able to meet its obligations?
- Can directors be held liable as 'shadow directors' by influencing the policy of subsidiaries in other jurisdictions?
- What is the 'tipping point' where the board must let creditor interest take precedence over creating and preserving shareholder value?
- What happens to intragroup receivables subordinated in the face of financial difficulties?
- At what stage must the board consult its shareholders in case of financial distress and does it have a duty to file for insolvency protection?
- Do special laws apply in the face of Covid-19 that suspend, mitigate or, to the contrary, aggravate directors' duties and liability risks?

There are more jurisdictions involved than you think

Most directors are generally aware of their duties under the governing laws of the country from which the company is run. However, individuals may also be directors of subsidiaries in other jurisdictions, either personally or indirectly through holding or management entities of which they are directors. And even if they are not, the laws that govern the subsidiaries may classify them as shadow directors of the subsidiary. All this may expose directors to duties and liability risks at local levels.

To complicate matters, liability may not only arise under local company law, but also under tort laws of countries where contracts are entered into that later cannot be performed, causing damages to the company's counterparties. Insolvency proceedings may be opened in yet more jurisdictions where the company or its subsidiaries do business and local insolvency laws may contain specific directors' duties and liability regimes.

Guidance to navigating these risks

We have put together an overview of the main issues facing directors in financially uncertain times in a number of key jurisdictions across the globe. This includes a brief general description of directors' duties and key areas of potential directors' liability in each country, as well as some answers to the questions listed above.

Obviously, the duties and liabilities that may arise will always be dependent on the circumstances. Therefore, this publication should not be used as legal advice when faced with a specific dilemma. However, we hope it may help to alert directors and their in-house advisors to the duties, pitfalls and liability risks that exist in major jurisdictions across the globe.

Germany

No.	Question	Answer
Directors' Duties		
1.	Do directors have to act primarily in the interest of their shareholders ('shareholder model' vs. 'stakeholder/Rhineland model', 'Revlon duties' in case of take-over bids) or do they have to take in account other stakeholders' interests as well? Does that regime change in case of financial distress?	Generally, managing directors (<i>Geschäftsführer</i>) of a German limited liability company (<i>Gesellschaft mit beschränkter Haftung</i> – GmbH) have to act in the interest of the company. It is disputed how the interest of the company is determined and to which extent stakeholder interests have to be taken into account. It is also debated in the literature, if there is a "shift of fiduciary duties" towards the creditors in the vicinity of insolvency. Although many voices are now in favour of such shift, the majority view is still against it. However, this obviously changes once the company is in insolvency proceedings in which managing directors have to secure the assets of the company in the interest of all creditors.
2.	What are the key areas of potential liability for directors when a company is in financial difficulties?	<p>There is a distinction between the internal and external liability of managing directors. Internal liability exists vis-à-vis the company and arises from the contractual and corporate relationship between the managing directors and the company. Internal liability results in claims of the company against a managing director; in insolvency proceedings, the insolvency administrator enforces such claims. Managing directors have to act with the care of a prudent businessman (<i>Sorgfalt eines ordentlichen Geschäftsmanns</i>). For business decisions (<i>unternehmerische Entscheidungen</i>), management can generally rely on the safe harbour of the business judgment rule if the prerequisites of this safe harbour are met. In particular, the managing directors need to decide on a full set of facts and free from a conflict of interests. Moreover, the business judgment rule is not applicable if management's decisions pose a threat to the viability of the business (<i>Existenzgefährdung</i>). In a crisis scenario, managing directors should thus in any event request independent advice and have the impact of relevant decisions clarified in light of the solvency of the company, e.g. by way of business judgment rule opinions and scenario analyses.</p> <p>External liability is an individual liability of managing directors towards third parties, such as creditors, individual shareholders, employees and the tax authorities. In particular, creditors can argue that the managing directors have delayed insolvency filing and thus they have suffered a loss, either in the form of a lower insolvency quota (<i>Quotenschaden</i>) or in the form of non-payment of contracts entered into after the insolvency of the company has occurred (<i>Neugläubigerschaden</i>).</p> <p>One of the key areas of potential liability for managing directors of companies in financial difficulties is the belated insolvency filing, which may lead to civil as well as criminal liability. In particular, a managing director is, <i>inter alia</i>, obliged to compensate the company for payments made after the company has become illiquid (<i>zahlungsunfähig</i>) or over-indebted (<i>überschuldet</i>) (see for more details no. 6).</p>

No.	Question	Answer
3.	Does liability rest only with formally appointed directors, or also with (other) officers or de facto directors? If so, what are the standards to qualify as such?	According to German case law, many duties and liability risks associated with managing directors' duties also apply to so-called "shadow directors" (<i>faktische Geschäftsführer</i>). A shadow director is usually a person who is not a managing director but acts as a managing director towards third parties.
4.	What are the standards for directors' liability for the company having entered into contracts that the company can later not perform ('wrongful trading')?	<p>Under normal circumstances, only the company becomes contractually bound and thus owes contractual duties, such as the duty to inform the contract partner of a financial crisis, towards the relevant contract partners. Such obligation to inform contract partners of a Crisis only arises where the Crisis is so imminent that the feasibility (<i>Durchführbarkeit</i>) of the relevant transaction is already severely endangered (<i>schwerwiegend beeinträchtigt</i>), or it is to be expected that the purpose of the transaction (<i>Vertragszweck</i>) will be ultimately defeated by a later insolvency. The hurdles can be lower, if there is a particularly close business relationship, e.g. where goods are sold on a regular (running) basis, or where transactions are booked on current accounts (<i>laufende Rechnung</i>).</p> <p>However, there are very narrow special situations where a managing director could become personally liable for not informing contract partners of a financial crisis. Apart from the high hurdles of intentional fraud (<i>Betrug</i>) (in particular where the managing director has made false representations with regards to the solvency of the company), this may be the case where a managing director has either: (i) assumed the special personal trust of the contract partner (<i>besonderes persönliches Vertrauen</i>); or (ii) has acted with economic self-interest (<i>wirtschaftliches Eigeninteresse</i>). The liability risk on the basis of (ii) above is very limited and in normal circumstances a mere theoretical risk. An economic self-interest is usually only relevant in straw-man cases. In addition, personal liability risks associated with cases under (i) above are also practically rare. In normal circumstances, the courts treat managing directors as representatives of the relevant company and do not hold them liable for not informing a contract partner of a Crisis. However, this could be treated differently where a managing director has made personal representations, in particular, where a managing director (falsely) represents that the company is in good shape and that they personally stand up for (<i>persönlich eintreten</i>) the correct performance of the company's contractual obligations.</p>
5.	What are the liability risks in the case of 'creditor stretching'?	In general, the mere fact that the company does not comply with its (payment) obligations towards its creditors is not in itself enough to establish personal liability for the managing director, except in the cases mentioned under no. 4 above and no. 10 below, or where the managing director is acting otherwise which needs to be qualified as <i>contra bones mores</i> . 'Creditor stretching' as a way to gain time for a refinancing will not typically lead to personal liability. The analysis, however, is very much dependent on the circumstances.

No.	Question	Answer
6.	<p>What are the liability risks in case of selective payments to some but not all creditors in case of liquidity issues? Is there a stage at which directors must treat all creditors equally?</p>	<p>Managing directors' of a company with limited liability are personally liable towards that company for "payments" which have been made by the relevant managing director or by an employee after the relevant company has become illiquid (<i>zahlungsunfähig</i>) or over-indebted (<i>überschuldet</i>). The aforementioned restriction does not apply to payments which are consistent with the diligence of a businessperson (<i>Sorgfalt eines ordentlichen Geschäftsmannes</i>).</p> <p>The definition of "payments" is very broad and encompasses every type of performance (<i>Leistung</i>) out of the company's assets, including payments by cheque, direct debits, set-off, non-monetary payments in kind or other forms of performances (e.g. the delivery of goods, the assignment of claims). This is also the case where the company receives funds from third parties on a company (current) account which is in-debt (<i>debitorisch geführt</i>), as the reduction of the debt-balance on such an account is considered a "payment" to the bank. The managing directors' must therefore ensure that after a company has become insolvent, payments by its customers or third parties are only made to accounts which stand to credit (<i>kreditorisch geführt</i>). On the other hand, payments from an in-debt account to third parties are possible, but only insofar the account is not secured by company assets.</p> <p>It is, however, possible to make "payments" or other types of performances which are directly (<i>unmittelbar</i>) and adequately compensated by a corresponding performance of or on behalf of the relevant recipient. It is important that the compensating performance is adequately usable (<i>verwertbar</i>) at the time of receipt by the company, ie it must not be immediately consumed or otherwise depleted. For instance, payments to employees are usually not adequately compensated as the performance of labour does not remain available to the company or its creditors. The compensation is calculated by using liquidation values (<i>Liquidationswerte</i>). It is further important that in case the compensation is directly paid into an in-debt (<i>debitorisch geführt</i>) account, such compensation payment must either be separated or directly used to acquire an adequately compensating asset. Hence, it must not be used to reduce the debt-balance towards the bank.</p> <p>A managing director is also liable for "payments" to shareholders (or their affiliated entities) which must have led to the company becoming illiquid (<i>zahlungsunfähig</i>) and where such payments are not protected by the businessperson privilege.</p>
7.	<p>Is there a distinction in this regard between preferential treatment of related entities and of other creditors?</p>	<p>Payments made by to a related entity may be subject to increased avoidance risks in insolvency, depending on the circumstances.</p>
8.	<p>Is there an obligation in case of financial difficulties to convene a shareholders' meeting and, if so, at what stage of financial difficulties?</p>	<p>Generally, shareholders meetings are to be convened in the cases determined in the by-laws, as well as whenever the best interests of the company so require.</p> <p>The managing director of a GmbH is obliged to convene the shareholders' meeting immediately if it results from the annual balance sheet or from a balance sheet drawn up in the course of the financial year that half of the share capital has been lost. If a managing director omits this duty of disclosure, they can be criminally liable.</p>

No.	Question	Answer
9.	Is there an obligation at some stage to file for bankruptcy or other statutory insolvency protection regimes?	Yes. The managing directors of a company with limited liability are obliged to file for insolvency as soon as (but in any event no later than three weeks after) it becomes illiquid (<i>zahlungsunfähig</i>) or over-indebted (<i>überschuldet</i>). The three week period may only be claimed (in full or in part) as long as promising negotiations on an out-of-court restructuring are underway. If an out-of-court restructuring can no longer be expected to succeed, the insolvency application must be filed immediately. Non-compliance with the filing obligation is a criminal offence by each managing director individually.
10.	Are there special liability risks in respect of certain debts, such as tax debts, social security payments, and pension contributions?	Yes. Non-payment of the employee's social insurance contributions (<i>Arbeitnehmeranteile zur Sozialversicherung</i>) to the relevant collection agency are a criminal offence under German law. Further, an employer has to transfer the collected wage taxes to the fiscal authorities within ten days after the end of each month. In the event of non-compliance, this is regarded as tax evasion, for which the managing director is personally liable. In case of partial retirement work agreements, the employer may be under the obligation to suitably safeguard (<i>absichern</i>) the credit balance including the employer's share of the total social insurance contribution attributable thereto against the risk of its insolvency. A director may be excluded from these liabilities under certain (rather strict) circumstances. Such analysis has to be made for each case individually.
11.	Are the liability risks of the directors collective (ie the whole board is responsible/liable) or individual? On what grounds can a director exculpate themselves from other directors' acts or omissions?	In principle, each managing director is liable individually. Whether a managing director can exculpate themselves is very much dependent on the individual circumstances of each case.
12.	Are there specific actions against directors under bankruptcy law?	Yes. Payments made after insolvency (see no. 6) can be claimed from each managing director by the insolvency administrator.

No.	Question	Answer
13.	Are there specific duties of (or consequences for) shareholders or other group companies at some stage of the financial difficulties, such as an automatic subordination or conversion into equity of debt to parent companies?	<p>Generally, the managing directors of a GmbH are under a mandatory statutory duty to file for insolvency if the company has become illiquid or over-indebted in the meaning of the German insolvency code. However, if there is no management (e.g. the managing directors have resigned), such mandatory duty is applicable to each of the shareholders instead.</p> <p>According to German insolvency law, shareholder loans are subordinated in insolvency proceedings. Non-demand (<i>Stehenlassen</i>) of shareholders' claims against the company may also be considered as shareholder loans; generally, this is the case for non-demand for more than three months. Such loans may, for example, be unpaid intra-group receivables for goods and services.</p> <p>Payments made to a shareholder within one year before the insolvency filing may be contested by the insolvency administrator.</p> <p>Assets made available to the company by a shareholder may not be claimed back for the period of one year from the commencement of the insolvency proceedings if the asset is of considerable significance for the continuation of the debtor's business. The shareholder shall receive compensation for the continued use of the assets.</p> <p>In case of a cash pooling within the group, the managing directors have to ensure that the company has comprehensive rights to information against the parent company or other member of the group managing the cash pool. The managing directors must implement an "early warning system" by which they can monitor the financial situation of the parent and the wider group in order to assess regularly the full recoverability of outstanding loans or the probability of a default which may incur third parties to call on guarantees or enforce security. Equally, the managing directors shall ensure that they can react in a fast and adequate manner on any threats detected by way of the early warning system, e.g. to leave the cash management system and to claim any outstanding funds.</p> <p>Shareholders have to obey the applicable capital maintenance provisions (<i>Kapitalerhaltungsvorschriften</i>).</p> <p>A shareholder can become liable if they take actions which have caused (<i>kausal herbeigeführt</i>) the collapse of the company (<i>existenzvernichtender Eingriff</i>). This may be the case where a shareholder has instructed the managing directors to systematically transfer assets to affiliated entities, the so-called "cold liquidation cases" (<i>kalte Liquidation</i>). Liability of the shareholder would be, as in the other cases, towards the company. These cases are rather exceptional and may also fulfil a criminal offence.</p>
14.	Is there special legislation mitigating the liability risks of directors specifically in view of the Covid-19 crisis?	<p>Yes. Due to the Covid-19 pandemic, the insolvency filing obligations for companies were under certain circumstances initially suspended until 30 September 2020 (and the suspension may be extended up to 31 March 2021). Parliament decided to extend the deadline for over-indebted (but not illiquid) companies to 31 December 2020. The suspension of the obligation to file for insolvency may only be invoked by managing directors who succeed in proving two cumulative conditions: first, insolvency must have been triggered by the effects of the Covid-19 pandemic and, secondly, there must be a real prospect of eliminating any existing illiquidity. Since it will obviously be difficult to prove that both conditions apply, legislators have introduced an additional legal presumption in favour of managing directors, under which the existence of both conditions is presumed if the company concerned was not illiquid (<i>zahlungsunfähig</i>) on 31 December 2019. If the management can therefore prove that the company was not illiquid at the end of 2019, it can invoke the suspension of the obligation to file for insolvency. However, the legal presumption is rebuttable, meaning that if it can be shown that the Covid-19 pandemic was not the cause of the insolvency (ie a ground for insolvency would have occurred even without the Covid-19 pandemic) or the elimination of the illiquidity is excluded (e.g. because refinancing negotiations had already ultimately failed), the obligation to file for insolvency is not suspended. According to the explanatory memorandum to the legislative proposal for the COVInsAG, however, the "highest demands" must be placed on any refutation of the legal presumption in order to ensure that the purpose of the law (ie to relieve liability and to protect the managing directors) is honoured.</p> <p>In case insolvency filing obligations are suspended, payments which are made in the ordinary course of business (especially those which serve to maintain or resume business operations or to implement a restructuring), shall be deemed to be consistent with the diligence of a businessperson (see no. 6).</p>

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