

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

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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

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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

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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.

# People's Republic of China

The discussions below are applicable to private limited liability companies incorporated in the People's Republic of China<sup>1</sup> (**PRC**), other than (a) state-owned or state-controlled enterprises, or (b) those that engage in regulated business activities which are subject to industry specific administrative rules (**PRC LLCs**).

These companies represent the vast majority of corporations in the PRC. Directors of state-owned or state-controlled companies (the **SOEs**), private companies limited by shares or public companies are subject to additional rules in terms of director duties and liabilities. For examples, directors of SOEs in general are more vulnerable to criminal liabilities for misconduct such as self-conducting of competing business, and directors of public companies are subject to additional duties under the PRC securities laws. For companies engaging in certain regulated business (e.g. financial institutions), special rules would apply which may subject its directors to extra duties and liabilities, such as personal attendance at more than two-thirds of the board meetings in a year and annual performance review.

No.	Question	Answer
<b>Directors' Duties</b>		
1.	Do directors have to act primarily in the interest of their shareholders or do they have to take the interest of other stakeholders (creditors, employees) into account as well? Does that regime change in case of financial distress?	<p>Pursuant to the PRC Company Law, the directors of a PRC LLC report to the shareholders; hence they must act primarily in the interest of the shareholders of the company, provided that such activities should not harm the national interest, public interest and legitimate rights and interests of any other person (such as the creditors of the company) and comply with the requirements of the PRC Constitution Law and General Provisions of the Civil Law of PRC.</p> <p>In particular, when a PRC LLC finds itself in financial distress and consequently (i) undergoes liquidation, or (ii) is effectively bankrupt<sup>2</sup>, there would be a shift in focus to the protection of "legitimate third party rights", which is demonstrated, among others, by the statutory order in the distribution of liquidation or bankruptcy proceeds. As a general remark, under both scenarios, the settlement of wages, social insurance payments, statutory employee compensations, tax payments and payments to third party creditors are given priority over shareholders. See detailed discussion in Q10.</p> <p>When a director is appointed as a member of the liquidation committee (which often is the case) for purpose of clearing the assets and liabilities of the PRC LLC, the creditors are entitled to claim damages against such directors for losses incurred due to a bad act on their part.</p>

1\_For the purpose of this discussion only, PRC excludes the Hong Kong Special Administrative Region, Macau Special Administrative Region and Taiwan.

2\_The PRC LLC is deemed bankrupt when unable to pay its debts due, having insufficient assets to pay off all its debts or becoming obviously insolvent (see article 2 of PRC Bankruptcy Law).



No.	Question	Answer
2.	<p>What are the key areas of potential liability for directors when a company is in financial difficulties?</p>	<p>Pursuant to the PRC Company Law, directors of a PRC LLC have certain fiduciary duties to the company, including without limitation the duty of loyalty and the duty of diligence. Directors are prohibited from abusing their position in the company for personal gains to the detriment of the company, and will be liable to the company for any such actions. Such rules also apply to the directors of PRC LLCs that are in financial difficulties.</p> <p>Below is a non-exhaustive list of actions by directors that may be deemed to be breaches of the duty of loyalty under the PRC Company Law, regardless of whether the company is in financial crisis:</p> <ul style="list-style-type: none"> <li>(a) misappropriating company funds;</li> <li>(b) depositing company funds into an account in their own name or in any other individual's name;</li> <li>(c) loaning company funds to a third party or providing a guaranty to a third party by using the company's property in violation of the articles of association without consent of the shareholders or the board of directors;</li> <li>(d) entering into a contract with the company or conducting transaction with the company in violation of the articles of association or without consent of the shareholders;</li> <li>(e) seeking business opportunities for themselves or any other person by taking advantage of their powers, or operating for themselves or for any other person any similar or competing business of the company without consent of the shareholders;</li> <li>(f) misappropriating commissions of a transaction between another person and the company;</li> <li>(g) disclosing company secrets without permit; or</li> <li>(h) taking other actions inconsistent with the obligation of loyalty to the company.</li> </ul> <p>Any director who acts in violation of the preceding paragraph, or who violates any law, administrative regulation, or the company's articles of association during the course of performing his/her duties, shall be liable for any losses incurred by the company as a result of such actions.</p> <p>Moreover, if a director commits any of the acts stated above, the shareholder(s) may require the board of supervisors (or the supervisor if there is no board of supervisors) to file a derivative lawsuit in a PRC court. If a director harms the shareholders' interests by violating any law, administrative regulation or the articles of association, the shareholders also may file a lawsuit themselves in a PRC court. Please refer to our reply to Q12 regarding directors' liabilities under the PRC Bankruptcy Law.</p>



No.	Question	Answer
3.	Does director's liability rest only on formally appointed managing directors, or also on others who perform managerial tasks?	<p>Directors' liability only rests upon formally appointed directors and not on others simply because they have a managerial responsibility.</p> <p>It is worth noting that under PRC laws, the legal representative of a company enjoys a higher authority and meanwhile assumes greater liabilities compared to an ordinary director, because they are deemed an authorised representative of a PRC company with full authorisation to act on behalf of the company. Under the PRC Company Law, the position of legal representative may be taken by the chairman of the board of directors or the single executive director (if the company does not have a board) or the general manager. The legal capacity of the legal representative is effective upon registration with the company registration authority.</p>
4.	What are the liability risks for directors if the company borrows new money or enters into new contracts but may not be able to perform the ensuing obligations?	<p>Under the PRC Criminal Law, a person unable to perform its obligations is deemed to have committed a contract fraud if the person defrauds the counterparty into concluding the contract for illegal procession of its property. If established, where the company is the signing party, the company and the legal representative, or persons directly responsible for such conduct, may be held guilty of a criminal offence. However, the criminal <i>mens rea</i> has a high threshold.</p> <p>Under the PRC Contract Law, a contract is revocable on the grounds of fraudulent activities and the contracting party at fault should bear civil liabilities for compensation of loss, although a director of the company should not be personally liable simply because of their position.</p>
5.	What are the liability risks in the case of 'creditor stretching'?	Creditor stretching may result in breach of contract by the company. PRC laws are silent on personal liabilities of directors in such a case.
6.	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>Selective payments by the PRC LLC, when the bankruptcy liquidity test is met, to some but not all creditors within six months prior to the court's acceptance of its bankruptcy application can be revoked if requested by the administrator, who is appointed by the PRC court to control the assets of such a company.</p> <p>Moreover, the administrator is entitled to petition the court to revoke the company's advance repayment of debts not due within one year prior to the court's acceptance of the bankruptcy petition, as such conduct is deemed intentional transfer of company assets with detriment to the interested parties in the potential bankruptcy procedure.</p> <p>If such selective payment harms the creditors' interests and the director of the company is directly responsible for such a conduct, the director may be held personally liable for indemnifying the creditors. Please refer to our reply to Q12 for details.</p>



No.	Question	Answer
7.	Is there a distinction in this regard between preferential treatment of related entities and the treatment of other creditors?	No.
8.	Is there an obligation in case of financial difficulties to convene a shareholders' meeting and, if so, at what stage of financial difficulties?	To convene a shareholders' meeting in case of financial difficulties is not a legal requirement applicable to PRC LLCs.
9.	Is there an obligation at some stage to file for bankruptcy or other statutory insolvency protection regimes?	According to the PRC Bankruptcy Law, only if a PRC LLC is dissolved without liquidation or before completion of the liquidation process and its assets are insufficient to pay off its debts, the person who is responsible for liquidation (i.e. the shareholders of the PRC LLC) is legally obliged to apply to the PRC court to initiate a bankruptcy liquidation process.
10.	Are there special liability risks in respect of certain debts, such as tax debts, social security payments, and pension contributions?	The PRC laws set out a hierarchy of debts to determine the order of distribution of bankruptcy proceeds but is silent on personal liabilities of directors. The bankruptcy proceeds must be paid in the order below, and shall be allocated pro rata among the interested parties of the same ranking: (a) debts in connection with the public interest as a statutory requirement (e.g. unpaid debts to construction contractors, in particular, the wages payable by a contractor to construction workers); (b) secured claims; (c) bankruptcy expenses; (d) common interest debts (i.e. certain debts incurred after the court accepts the bankruptcy petition); (e) employee claims, including unpaid salaries; (f) medical and disability subsidies, basic old-age and medical insurance premiums, and statutory compensations; (g) social insurance premiums and outstanding tax; and (h) common (unsecured) claims in bankruptcy.



No.	Question	Answer
11.	Are the liability risks of the directors collective (i.e. the whole board is responsible/liable) or individual? On what grounds can a director exculpate themselves from other directors' acts or omissions?	<p>Usually collectively, if a decision is made in the form of a board resolution. If directors specifically disagree with a resolution (and this is documented), they should be exempted from the liabilities.</p> <p>It is worth noting that the PRC Company Law imposes a certain statutory duty on directors of a company limited by shares, whereby a director is personally liable for board resolutions in violation of laws and regulations, articles of association and shareholders' resolutions. Such a rule is not legally applicable to the directors of a limited liability company, although in practice it is not unusual for a limited liability company to adopt similar rules in its articles of association to limit the authority of the directors.</p>
12.	Are there specific actions against directors under bankruptcy law?	<p>A director will be liable for breaching the duty of loyalty and/or the duty of diligence, if this results in the bankruptcy of the PRC LLC. Moreover, if the PRC LLC is bankrupt or forced to shut down by PRC government authorities and the director is personally liable for such bankruptcy or closure of business, such director will be forbidden to serve as a director, supervisor or senior officer in another PRC LLC for the subsequent three years.</p> <p>Under the PRC Bankruptcy Law, if a PRC LLC commits any of the acts set out below and harms the interests of the creditors, the "directly responsible person" would be held liable for indemnifying the creditors. "Directly responsible person" is not explicitly defined, but can be generally interpreted as the person who plays a role to the extent of deciding on, approving, authorising, conniving at or directing such bad act implemented by the PRC LLC. A director of the PRC LLC can be deemed a "directly responsible person", and thus be held liable for indemnification, if falling within such interpretation.</p> <ul style="list-style-type: none"> <li>- Within one year prior to the court's acceptance of the bankruptcy application made by a PRC LLC, such PRC LLC: <ul style="list-style-type: none"> <li>(i) transfers its assets for free;</li> <li>(ii) conducts transactions at a manifestly unreasonable price;</li> <li>(iii) provides collateral to unsecured debts;</li> <li>(iv) pays off debts that are undue; or</li> <li>(v) waives any creditor rights.</li> </ul> </li> <li>- Within six months prior to the court's acceptance of the bankruptcy application, the PRC LLC makes selective repayment to certain creditors after it becomes unable to pay its debts when due, having insufficient assets to pay off all its debts or is obviously insolvent.</li> <li>- The PRC LLC conceals or transfers its assets to evade debts, fabricates debts or admits unreal debts.</li> </ul>



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?	Not under PRC laws.
14.	Is there special legislation mitigating the liability risks of directors specifically in view of the Covid-19 crisis?	Not in the form of legislation or national policies as of the date of this discussion.

\*Services in relation to the laws of the People's Republic of China are provided through Allen & Overy Lang Yue (FTZ) Joint Operation Office.



## Contacts

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**Jane Jiang**

Partner

Tel +86 21 2036 7018

[jane.jiang@allenoverly.com](mailto:jane.jiang@allenoverly.com)



**Wenxin Zhou**

Partner

Tel +86 21 2067 6815

[wenxin.zhou@allenoverly.com](mailto:wenxin.zhou@allenoverly.com)



For more information, please contact:

## London

Allen & Overy LLP  
One Bishops Square  
London  
E1 6AD  
United Kingdom

Tel +44 20 3088 0000  
Fax +44 20 3088 0088

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