

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.



The United States (Delaware)

No.	Question	Answer
Directors' Duties		
1.	Do directors have to act primarily in the interest of their shareholders or do they have to take in account other stakeholders' interests as well? Does that regime change in case of financial distress?	Directors owe their duties to the shareholders as a whole when the company is solvent and to the stakeholders as a whole when the company is insolvent. In rare circumstances, a creditor of an insolvent company may assert, on a derivative basis, breach of fiduciary duty claims the company may have against its directors. Creditor derivative standing is generally available only with respect to corporations, and not LLCs and partnerships, due to differences in the statutory regimes, but in at least one case, an amendment to the LLC agreement was made in bankruptcy to permit creditors to bring derivative claims (such claims may be brought derivatively on behalf of a solvent company only by the company's shareholders).
2.	What are the key areas of potential liability for directors when a company is in financial difficulties?	Whether the company is solvent or insolvent, directors have the protection of the business judgment rule. Under the business judgment rule, directors are generally insulated from liability for business decisions that were made on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company. As the directors' duties are those of loyalty and care, a director will be liable only for conduct that was self-interested, in bad faith or without due care (bearing in mind the significant deference to directors' judgment afforded by the business judgment rule) and resulted in loss of value for the company.



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?	<p>Corporate officers owe the same fiduciary duties as directors. Corporate officers include a company's president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer and chief accounting officer, or other position of similar seniority and responsibility.</p> <p>A controlling shareholder also owes fiduciary duties to minority shareholders such that it must put the interests common to all shareholders ahead of those interests which are exclusive to itself. Whether a given shareholder is "controlling" turns on its ability to influence corporate action (such as through a veto or blocking vote position) and possession of a majority or supermajority of shares is not required.</p>
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>There is no cause of action under US or Delaware law for 'wrongful trading'; directors are protected from liability for continuing to operate in the good faith belief that they are pursuing a strategy to return the company to profitability. As noted above, a director may be liable to the company, its shareholders and/or its creditors as a whole if they entered into the new obligations in violation of their duties of good faith and due care and incurring the new obligations caused damage to the company. A director will not be liable specifically to the counterparty of the new obligation.</p>
5.	What are the liability risks in the case of 'creditor stretching'?	<p>Directors are not personally liable for a company's failure to make timely payments to its creditors and may cause the company to delay payments to creditors if doing so is, as a matter of their business judgment, in the best interests of the company.</p>
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>Directors may favour particular creditors if doing so is, as a matter of their business judgment, in the best interests of the company.</p>



No.	Question	Answer
7.	Is there a distinction in this regard between preferential treatment of related entities and the treatment of other creditors?	Preferential treatment of insiders or related parties may be subject to attack as breaching the fiduciary duty of loyalty to the best interests of the company and its stakeholders (including creditors).
8.	Is there an obligation in case of financial difficulties to convene a shareholders' meeting and, if so, at what stage of financial difficulties?	No, unless there are specific provisions in the charter, bylaws or member agreement requiring such a meeting. The requirements to authorize a bankruptcy filing will generally be specified in the bylaws or member agreement.
9.	Is there an obligation at some stage to file for bankruptcy or other statutory insolvency protection regimes?	No, a company is not required to file for bankruptcy upon becoming insolvent and a company may file for bankruptcy protection even if it is not insolvent. However, directors may face liability for breach of fiduciary duty if they fail to take appropriate protective action, such as a bankruptcy filing, in the face of creditor enforcement actions such as foreclosure on significant company assets.
10.	Are there special liability risks in respect of certain debts, such as tax debts, social security payments, and pension contributions?	<p>Yes, under the laws of certain states, officers and directors may be personally, and even criminally, liable for the failure to pay wages and benefits. The applicability of state employment laws will depend on the presence and number of employees in the state in question. Note also that state law may impose personal liability for unpaid wages, benefits, pension contributions and insurance premiums on a joint and several basis against shareholders of privately owned employers (even if they are incorporated elsewhere).</p> <p>In some circumstances, directors may be deemed "employers" under the federal Fair Labor Standards Act and be personally liable for the failure to pay a minimum wage; there is, however, a defense of good faith belief that the wages paid complied with the law.</p>



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?	Liability of directors is individual and not collective; however, a director may violate their fiduciary duty of loyalty or due care by failing to respond appropriately to another director's misconduct. Requiring recusal of interested directors or forming a special committee comprised solely of independent directors to consider a particular issue are common ways of ensuring that a board's decision-making can be protected by the business judgment rule even if certain members may have conflicts of interest.
12.	Are there specific actions against directors under bankruptcy law?	No, but breach of fiduciary claims under state law may be asserted in bankruptcy for the benefit of the creditors of the company.
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?	There is no automatic conversion of debt to equity, but loans by shareholders or parent companies may be recharacterized as, and subordinated to the level of repayment of, equity in bankruptcy if such treatment is more consistent with the nature of the obligation, regardless of its formal structuring as a debt instrument.
14.	Is there special legislation mitigating the liability risks of directors specifically in view of the Covid-19 crisis?	No.



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