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.

Belgium

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 are under an obligation to properly fulfil their mandate to manage the company, as well as under a general duty of care not to harm the company or any other third party. When taking decisions, directors must act in the 'best interest of the company', referring primarily to the interest of the shareholders, but also of other stakeholders (such as employees, customers, suppliers, creditors), as they also have an interest in seeing the company succeed and continue. Directors therefore need to strike a balance between the short-term benefits to the company of their decisions, and the long-term impact that those decisions might have on the extended group of stakeholders. When the company gets into financial distress, the above-mentioned regime will still apply and directors will still be bound by a general duty of care and diligence. However, the focus of directors will shift from shareholders to creditors (including employees and debt providers) as financial difficulties worsen and shareholder value evaporates.

No.	Question	Answer
2.	What are the key areas of potential liability for directors when a company is in financial difficulties?	Under Belgian company law, there are two types of directors' liability: (i) *internal liability*, meaning that the directors are liable vis-à-vis the company and its shareholders for management mistakes that occurred in the performance of their duties, and (ii) *external liability*, meaning that the directors are liable vis-à-vis third parties for non-contractual faults. Intentional or negligent acts or omissions may lead to a director's personal liability. Liability will be assessed according to the minimum standard of a normal, prudent and diligent director with the same professional qualifications, thus allowing the director a reasonable degree of latitude. Courts and tribunals can sanction only gross and obvious faults that fall outside the said margin of discretion (*marginale toetsing*). In addition, a director is vis-à-vis the company and third parties jointly and severally liable for all damage resulting from non-compliance with the Belgian Code of Companies and Associations (**BCCA**) and the company's articles of association. Aside from these general principles, the BCCA and the Belgian Criminal Code contain a number of provisions that specifically deal with a director's liability in the context of a company's bankruptcy or insolvency. There are seven main areas of concern for directors of companies in financial difficulty, each of which will be considered in turn below: (1) liability for failure to file for bankruptcy; (2) liability for apparent gross error contributing to the company's bankruptcy; (3) founders' liability if the company's assets or capital are insufficient at incorporation; (4) liability for failure to convene a shareholders meeting following a decrease in net assets; (5) liability for wrongful trading; (6) liability for social security contributions that remain unpaid when a director has already been involved in two bankruptcy proceedings in the previous five years; and (7) criminal liability.
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?	As clarified in the newly adopted BCCA, not only formally appointed managing directors, but also *de facto* or shadow directors (i.e. persons that – independently and without receiving any orders – perform positive acts of management without being properly bound to the company by a contractual mandate) can be held liable towards the company or third parties as explained in point 2 above. In addition, in groups of companies a parent or sister company may be considered a *de facto* or shadow director of another company in the same group, if the parent/sister organisation directly intervenes in the management decisions of that other company (that is, if it 'pulls the strings').

No.	Question	Answer
4.	What are the standards for directors' liability for the company having entered into contracts that the company can later not perform ('wrongful trading')?	Directors and *de facto* or shadow directors may be (personally or jointly and severally) held liable for (part of) the remaining debts of the bankrupt company in the event that those directors, prior to the bankruptcy, knew or should have known that there was no reasonable prospect of continuing the company's activities and of avoiding a bankruptcy – provided they failed to act as would normal, prudent and diligent directors in the same circumstances.
5.	What are the liability risks in the case of 'creditor stretching'?	Creditor stretching, through which a company makes the deliberate decision to pay critical suppliers ahead of others due to limited financial means, is not in and of itself a way to hold the managing directors personally liable, as it might be a way to gain more time to restructure the company. However – and this will have to be assessed on a case-by-case basis – personal liability could be triggered and managing directors will be strictly scrutinised should they purposely decide to pay a certain category of creditors (e.g. connected creditors) ahead of others (e.g. outside creditors) if there is no reasonable prospect of restructuring.
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?	As stated above, selective payments to some crucial creditors ahead of others is not, in and of itself, sufficient to establish personal liability, provided there is a reasonable prospect of restructuring. Managing directors are tasked with the management of the company and should be allowed to take strategic decisions in this regard. However, in the absence of a reasonable prospect of restructuring, there is no more justified reason to treat creditors differently, and directors should opt for equal treatment of all creditors.
7.	Is there a distinction in this regard between preferential treatment of related entities and the treatment of other creditors?	As stated above, selective payments do not necessarily establish liability, as long as there is a reasonable prospect of restructuring. As a general principle, directors should act in the way a normally diligent and prudent director would act if placed in the same circumstances. Directors will not fulfil this standard if they decide to pay certain creditors ahead of others with no prospect of restructuring, as this could amount to pursuing a loss-making activity, which is unreasonable.

No.	Question	Answer
8.	Is there an obligation in case of financial difficulties to convene a shareholders' meeting and. if so, at what stage of financial difficulties?	**Private limited liability company (*besloten vennootschap/sociétée à responsabilité limitée*) or limited partnership (*commanditaire vennootschap/société en commandite*)** For these companies, the BCCA provides that a general meeting of shareholders must be convened for the purpose of passing a resolution to wind up the company (i) if the company's net assets will or have become negative, or (ii) when management decides on the basis of reasonably foreseeable developments that it is uncertain whether the company will be able to pay its debts for at least the following twelve months. **Limited liability company (*naamloze vennootschap/société anonyme*)** For these companies, the BCCA provides that a general meeting of shareholders must be convened for the purpose of passing a resolution to wind up the company (i) when the company's net assets have fallen below 50% of the share capital, (ii) when the company's net assets have fallen below 25% of the share capital, and (iii) in the worst-case scenario, when the net assets are reduced below EUR 61,500. **Consequences of obligation to convene** If any of those scenarios occurs, directors have to convene a general shareholders meeting within two months after the loss has been ascertained (or should have been ascertained) by the directors. At the shareholders meeting, the shareholders must decide whether to wind up the company. If there is any breach of these provisions, the directors may be held jointly and severally liable for all or part of the losses occurring after the date the shareholders meeting should have been convened. Claims against directors on this basis can be made by the bankruptcy receiver as well as by third parties (such as individual creditors). When claims are initiated by third parties, a rebuttable presumption applies that the losses suffered by those third parties are caused by the fact that no shareholders meeting was held; the damage suffered by third parties shall, subject to evidence to the contrary, be deemed to result from the absence of a convening notice.

No.	Question	Answer
9.	Is there an obligation at some stage to file for bankruptcy or other statutory insolvency protection regimes?	A company is in a state of bankruptcy if two cumulative conditions are met: (i) the company has ceased to pay its debts, that is, when it can no longer pay its main creditors in a timely fashion (permanent cessation of payment), and (ii) creditors no longer trust the company (exhaustion of the credit). The directors of a company are required to file for bankruptcy within one month after the moment these conditions are fulfilled. This obligation applies only to formally appointed managing directors. At the moment the Business Court declares the company bankrupt, the directors no longer have control of the company and a court-appointed trustee will take over. A failure to file for bankruptcy within one month after the company has ceased to pay its debts may result in the following liabilities for directors: – personal liability for any increase in the level of indebtedness of the company because of the delay in filing for bankruptcy; – joint and several liability for all debts of the company, if it can be shown that their actions have contributed to the company's insolvency and that their actions constitute an apparent gross error (see further below); and/or – criminal liability, but only if it can be shown that they had intent to postpone or avoid a bankruptcy order (see below). The obligation to file for bankruptcy will be suspended if the indebted company's directors have filed for judicial reorganisation, for as long as the moratorium period granted under it continues to run. These judicial reorganisation proceedings are intended to allow a company to restructure its business under the court's supervision and to avoid an order of bankruptcy.
10.	Are there special liability risks in respect of certain debts, such as tax debts, social security payments, and pension contributions?	A director can be held liable for unpaid tax debt if he has committed a fault, or has failed to exercise due diligence. The burden of proof is on the tax authorities. There is no automatic liability. As stated above, directors have a margin of discretion when taking decisions, and this implies that only gross faults will be sanctioned, with reference to the standard of the normally prudent and diligent director. A more special rule applies in case of continued failure to pay tax debts, in which case the burden of proof will be reversed: a presumption of liability will apply if tax debts have not been paid at least twice within a period of one year. The (former) directors and *de facto* or shadow directors can also be held personally (as the case may be, jointly and severally) liable for all or part of the unpaid social security contributions owed at the time of the court's bankruptcy order. Contrary to the liability regime applicable to unpaid tax debts, no fault on the part of the (former) director(s) should be proven. It suffices that, during the five years preceding the bankruptcy, such persons can be shown to have been involved – as a director or *de facto* or shadow director – in at least two bankruptcies, liquidations or similar operations wherein debts owed to an institution authorised to collect social security contributions were left unpaid. Liability claims based on this ground can be made by the bankruptcy receiver or by the social security authorities.

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?	When the board of directors forms a collegiate body, members will be held jointly and severally liable for any breach of directors' responsibilities. A director may exculpate themselves from other directors' acts or omissions if they can demonstrate that (i) they have not taken part in the faults committed by the others, and (ii) they denounced those faults to all members of the board of directors.
12.	Are there specific actions against directors under bankruptcy law?	We refer to the seven main areas of concern for directors of companies in financial difficulty, set out under point 2. More specifically, any current directors, former directors, and all other persons who had actual authority to manage and administer the company's business (*de facto* or shadow director) may be jointly and/or severally liable for all or part of the debts of the company to the extent that there is a deficit of the company's liabilities as against its remaining assets (which will almost always be the case). This liability will apply only insofar as it is found that these persons committed an apparent gross error that contributed to the bankruptcy. This liability does not require the error to be the determining cause of the bankruptcy (or underlying debts). It suffices that without the error the bankruptcy (or underlying debts) would not have occurred in the same way. The concept of an 'apparent gross error' implies that only serious errors which any reasonable person would consider wrongful will trigger liabilities. A court will need to show great deference in assessing the director's conduct, and it may not substitute its own judgment in hindsight for that of the directors, made in light of the facts available at the time. Serious tax fraud will always be viewed as an apparent gross error that contributed to the bankruptcy. In addition, case law has established that the following situations will generally trigger personal liability for the company's liabilities on bankruptcy: – the continuation of a significantly loss-making activity (in certain cases) *[NB: the liability for wrongful trading has now also been codified]*; – making investments which significantly exceed the company's financial means (in certain cases); – in the case of financial difficulty, drastically changing the company's business without any reasonable grounds for believing in its financial sustainability; – the total absence of any administration or book-keeping; or – a manifest disinterest in the company and total lack of control over the company's daily business.

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?	Belgian law does not provide that financial difficulties trigger specific duties of, or consequences for, shareholders or group companies.
14.	Is there special legislation mitigating the liability risks of directors specifically in view of the Covid-19 crisis?	At the moment, there is no special legislation in place to mitigate the liability risks of directors in view of the Covid-19 crisis. However, on 24 April 2020 a Royal Decree entered into force concerning the temporary suspension of enforcement measures and other measures during the Covid-19 crisis. This Royal Decree was applicable to all undertakings whose continuity was threatened by the Covid-19 crisis (e.g. due to a significant decline in turnover or activities, temporary or full technical unemployment; and/or mandatory temporary closure ordered by the public authorities), and which were not yet in a state of cessation of payments before 18 March 2020. A temporary moratorium was created and the Royal Decree provided, among other things, for a suspension of the director's statutory duty to file for bankruptcy within one month of the date of cessation of payments. These rules are no longer applicable: the suspension applied from 24 April 2020 until 17 May 2020 and was extended by Royal Decree to 13 May 2020 until 17 June 2020.

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