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.

Italy[1]

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 shall primarily act in the company's interest and they are subject to a duty of care towards all the company's stakeholders, including the shareholders, the creditors and other third parties. In particular, certain articles of the Italian civil code assign to directors a general duty of loyalty not to act against the company's interest, which is largely understood by scholars as an autonomous entity that is more than the mere sum of each shareholder's single interest. Moreover, pursuant to the Italian civil code, directors are responsible vis-à-vis creditors for the maintenance of the assets of the company and towards third parties for any wrongdoing which caused damage. The regime changes in the case of financial distress, where the company must act primarily in the best interest of its creditors. Lastly, the regime applicable when a cause for the dissolution of the company occurs provides that directors continue to keep their management power over the company with the only purpose of preserving the integrity and value of the company's assets. To such extent, directors are liable vis-à-vis the company, the shareholders, the company's creditors and third parties for any damage caused in violation of the aforementioned duty.
2.	What are the key areas of potential liability for directors when a company is in financial difficulties?	The civil liability of directors in connection with financial difficulties may arise from the breach of both duties of prevention and management of the crisis. With reference to: – prevention matters, directors have two duties: (i) granting the maintenance of the assets of the company; and (ii) establishing an adequate organisational, administrative and accounting structure, appropriate to the nature and size of the company, such as to detect the company's state of insolvency and the loss of going concern status on a timely basis and be able to promptly adopt and implement one of the instruments provided for by law to enable undertakings to overcome financial difficulties and recover going concern status; – management of financial difficulties matters, directors have the duty to (i) timely adopt and implement one of the instruments provided by the law; and (ii) accord equal treatment to all creditors (unless benefiting certain creditors is the only way to preserve the company's value, see under 6). Criminal liability generally refers to activities or omissions carried out by directors that, wilfully or negligently, tend to deceive on the financial distress of the company and/or jeopardise the corporate capital.

1_This note relates only to the general provisions as the same are in force and construed at the date hereof (i.e. 3 July 2020). The following answers contain a high-level contribution also with regard to the criminal law aspects, which however cannot be considered in any way as legal advice and/or exhaustive inputs considering that A&O Milan does not have the capability to provide any criminal law advice whatsoever.

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 Italian case law and scholars, shadow directors are subject to the same duties and liabilities as directors vis-à-vis the company, the shareholders, the creditors and third parties. However, it is debated among scholars whether a shadow director can be held liable for not complying with duties which can be performed only by virtue of a formal appointment (e.g. calling a shareholders' meeting when mandatory according to Italian law). According to Italian case law, qualifying elements which may be relevant to determine whether an individual may be considered a shadow director are: – substantial (also in terms of economic significance) and continuous exercise of directors' typical powers, both internally and towards third parties (e.g. commercial, accounting and administrative activities); – performance of a variety of functionally and systematically coordinated acts of management; – involvement in decisions which affect the operation of the business; – actual involvement in relevant or strategic transactions (e.g. M&A transactions, real estate transactions and financial transactions); and – being recognised by third parties as an effective representative of the company.
4.	What are the standards for directors' liability for the company having entered into contracts that the company can later not perform ('wrongful trading')?	In general terms, Italian law does not provide for a specific hypothesis of liability of directors for entering into contracts that the company can later not perform ("wrongful trading"). In any event, in such circumstances, directors may be held liable and therefore be requested to compensate the relevant damages for the breach of duties they owe to the company's creditors for maintenance of the assets of the company (also for the cause of/increase in the status of insolvency of the company) and/or breach of the general duties of care which caused direct damages to shareholders and third parties pursuant to certain provisions of the Italian civil code. Such provisions set out the general principles on the conduct and behaviour of directors and therefore their liability pursuant to such rules shall be assessed on a case-by-case basis. Alongside their liability for damages vis-à-vis the relevant counterparty/the company, directors may personally also be held liable from a criminal perspective in the case where they have entered into new obligations on behalf of the company wilfully intending not to perform them in light of the dissimulated state of insolvency of the company ("fraudulent trading"). When the above-mentioned crime is integrated, from a civil perspective, directors may be held liable for damages arising from the commission of said crime. Please consider also that bankruptcy law provides for the criminal liability of, among others, directors for borrowing or continuing to borrow money, dissimulating the insolvency or the crisis of the company. Should the intention not to perform the relevant obligations arise later (e.g. at the time of the actual performance) or in consequence of a reason other than the insolvency of the company (e.g. a personal reason), there should not be criminal liability but directors may be held liable for damages anyway, according to case law. In any event, directors should take care not to mislead their counterparties in relation to the company's financial situation, paying due consideration to the distinction between wrongful trading and fraudulent trading which often tends to get blurred in light of factual circumstances.

No.	Question	Answer
5.	What are the liability risks in the case of 'creditor stretching'?	The directors' decision on behalf of the company not to comply with payment obligations with the intention to fulfil them at a later stage, through a refinancing or restructuring remedy, could expose them to personal liability should the company fail to fulfil such obligations or become insolvent before paying the obligations undertaken. Furthermore, directors have a specific duty to establish an adequate organisational, administrative and accounting structure, as specified under 2 above. Accordingly, depending on factual circumstances, "creditor stretching" may even amount to early warning of an upcoming crisis which should be detected by directors in order for them not to be held liable in the case of a deterioration in financial conditions resulting in a prejudice to the creditors' claims. If only third-party creditors are "stretched" but debts to related parties (such as subsidiaries, associated parties etc.) are paid on time, directors' liability for damages and, in the event of subsequent bankruptcy, also criminal liability (see under 6) may ensue, also considering that shareholders' financial claims against the insolvent company are in principle ranked junior with respect to external claims (see under 7).
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?	The directors' decision to prefer one or some creditors over others may lead to both civil and criminal consequences in the event of bankruptcy. Should funds available to the company be insufficient to pay all creditors, directors should, insofar as possible, try to limit payments to those strictly necessary to the company's short-term survival, vis-à-vis creditors instrumental for the company to maintain going concern status (employees and certain suppliers), only as long as this decision is made from the realistic perspective of preserving value in the company's assets to the benefit of all creditors. Amongst such creditors, priority should be given to those whose claims are ranked senior under bankruptcy law (e.g. employees). In the absence of any credible perspective of preservation of the company's value, directors should strive to accord equal treatment to all creditors and, if possible, suspend all payments in light of imminent pre-insolvency or insolvency procedures. Ultimately, the precise moment when directors should decide to accord equal treatment to creditors varies and should be evaluated carefully by directors the more the company's struggle to pay all creditors intensifies.
7.	Is there a distinction in this regard between preferential treatment of related entities and the treatment of other creditors?	At least some of the related entities' financial claims, such as those of shareholders, are ranked junior to, by law, those of third-party creditors (for further details, see question 13 below); it follows that the decision to pay them and leave third-party creditors unpaid may undoubtedly result in director liability in the event of subsequent bankruptcy or failure to fulfil the company's other obligations. In any event, without prejudice to what is discussed under question 6 above, no distinction is made in principle between related entities and other creditors in relation to trade receivables deriving from transactions performed at arm's length with the company.

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?	Under Italian law, directors shall immediately convene a shareholders' meeting when the company suffers losses as a consequence of which the corporate capital is decreased by more than one-third. The shareholders shall then adopt the appropriate measures to assess the financial situation of the company and:[2] – if within the following financial year the loss is not diminished to less than one-third of the corporate capital, then the shareholders' meeting shall reduce the corporate capital accordingly; – if, due to the loss of more than one-third of the corporate capital, said corporate capital falls below the minimum required pursuant to the law, the shareholders' meeting shall immediately restore it or transform the company. Moreover, in case neither the restoring of the corporate capital nor the transformation of the company are possible or resolved by the shareholders' meeting, directors shall timely file the winding up of the company with the Italian Companies' Register and convene the shareholders' meeting to resolve the liquidation of the company.
9.	Is there an obligation at some stage to file for bankruptcy or other statutory insolvency protection regimes?	Although there is no specific deadline,[3] according to Italian bankruptcy law, within which the directors of a distressed company are required to file for insolvency proceedings, it is provided that: – directors must implement the structure described under 5 above; and – immediately implement one of the legal tools provided for by Italian bankruptcy law to overcome the crisis and safeguard the continuation of the business. Failure to comply with the above-mentioned obligations and, more generally, late detection and management of the crisis may generate some civil and criminal liabilities for directors.
10.	Are there special liability risks in respect of certain debts, such as tax debts, social security payments, and pension contributions?	From a general perspective, non-compliance with mandatory payments (both from a tax and social security point of view) due to a decision of a director can result in his/her liability to pay damages to shareholders and/or the company. Joint liability of directors is also provided by the Italian civil code for non-compliance with obligations provided by the law (including payment of taxes and social contributions), in relation to certain types of legal entities (e.g. limited liability companies) unless they prove that non-compliance was not due to their fault, they could not avoid it and they expressly recorded their disagreement in the minutes of the board of directors' meetings (in this respect, specific duties/rules may be provided, depending on the type of legal entity). Finally, non-payment of taxes and social security contributions may also be punished from a criminal point of view, if certain thresholds are exceeded.

2_Covid-19 emergency legislation provides that, between 9 April and 31 December 2020, by way of exception to the ordinary rules, both the recapitalisation obligations of companies and the obligation to wind up companies as a result of the reduction in share capital below the minimum amount required by law are suspended. However, directors are still required by law to call shareholders' meetings in order to provide shareholders with appropriate information with respect to the company's economic and financial situation. However, due to its recent implementation and lack of case law it is unclear whether such rule would apply in cases where the crisis situation existed before the Covid-19 outbreak.

3_Please note that, in order to deal with the effects of the Covid-19 outbreak on business continuity of Italian companies as going concerns, certain temporary law provisions have been enacted by the Italian government. In particular, please note that any filings for the declaration of bankruptcy or for the ascertainment of the state of insolvency brought within the period between 9 March 2020 and 30 June 2020 were deemed inadmissible (improcedibili) and had to be filed again after the expiration of such period. However, there is some recent case law in such respect based on which it appears that this would not apply in cases where the crisis situation existed before the Covid-19 outbreak. In any case, it did not apply to the filing made by the company itself (i.e. not by any third-party creditor] in cases where the crisis situation existed before the Covid-19 outbreak.

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?	Directors of joint-stock companies (*società per azioni*, **SPA**) can be considered as jointly and severally liable for damages deriving from non-compliance with their duties, except for functions vested solely in either the executive committee or one or more directors. SPA directors are jointly liable if, having knowledge of conduct being prejudicial to the company, they fail in doing what is in their powers to prevent that and either remove or reduce its harmful consequences. Any such liability does not extend to those directors who, being blameless, requested their dissent to be recorded without delay in the minutes of the company board of directors' meetings (*libro delle adunanze e delle deliberazioni del consiglio di amministrazione*) and immediately informed in writing the chairman of the board of statutory auditors. Also, directors of limited liability companies (*società a responsabilità limitata*) are jointly and severally liable towards the company for damages arising from their failure to comply with the duties imposed on them by law or company by-laws, except for directors who, being blameless and having knowledge of the occurrence of such act, requested their dissent to be recorded.
12.	Are there specific actions against directors under bankruptcy law?	In general terms, Italian bankruptcy law provides that the bankruptcy receiver (*curatore fallimentare*) may, with the prior authorisation of the delegated judge (*giudice delegato*), bring any liability actions against directors which, in the ordinary context, would be brought either by the company itself, the shareholders or the company's creditors.
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?	The Italian civil code sets out a general rule according to which the loan granted to a limited liability company (*società a responsabilità limitata*) by the relevant quotaholders[4] shall be subordinated (*postergato*) to any other creditor of that company, if at the time the loan is advanced: – there is an imbalance between the company's indebtedness and its net asset value (also taking into account the corporate purpose of the company); and – the company's financial situation would have required an equity contribution instead of a loan. It is reasonable to argue that loans granted by quotaholder(s) under the above-mentioned circumstances are subject to an equitable subordination principle and if repaid by the company during the year before the bankruptcy declaration shall be returned back to the company. In addition, please consider that the above-mentioned rule applies with reference to loans disbursed during the year prior to the bankruptcy declaration. Indeed, under Italian bankruptcy law, the receiver is generally acknowledged to act for the ineffectiveness of the repayment of loans (and consequent obligation to repay them by quotaholders) disbursed up to two years before the bankruptcy declaration. In this case, however, the aforementioned imbalance situation must not exist only at the time of disbursement but also at the time when the repayment is made.[5]

4_In accordance with the prevalent scholars, this rule applies also when the loan is disbursed by any other company of the group (other than in the case of any upstream loans). Moreover, it is generally maintained that such rule also applies (at least in certain cases) when a loan is granted to an SPA by the relevant shareholder.

5_Please consider that, in order to deal with the effects of the Covid-19 outbreak on business continuity of Italian companies as going concerns, certain temporary law provisions have been enacted by the Italian government. In particular, some measures have been introduced which are currently applicable to quotaholder (or shareholder) loans made from 9 April to 31 December 2020, for the suspension of rules regarding subordination of such quotaholder (or shareholder) loans pursuant to the Italian civil code. However, please note that it is not clear whether such provisions would also apply in the case where the company's asset imbalance situation (squilibrio patrimoniale) already existed before 9 April 2020 and, considering the very recent enactment of those measures, please be aware that there is no specific case law in such respect.

No.	Question	Answer
14.	Is there special legislation mitigating the liability risks of directors specifically in view of the Covid-19 crisis?	Although there is no specific legislation directly mitigating directors' liability risks, in addition to what has been already mentioned under paragraphs 8, 9 and 13, Covid-19 emergency legislation also provides for some temporary provisions on preparation of balance sheets. Indeed, with the aim of facilitating the continuation of businesses as going concerns, in the preparation of corporate balance sheets relating to the ongoing financial year (or, if such balance sheets are yet to be approved, relating to the financial period ending before 23 February 2020), directors' evaluations can be made as if the relevant business activity is still continuing if such continuation is shown in the previous balance sheet relating to the financial period ending before 23 February 2020 (being the date on which the first emergency legislation was enacted).[6]

6_The extent of application of the provision is unclear due to its recent implementation (and consequent lack of case law).

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