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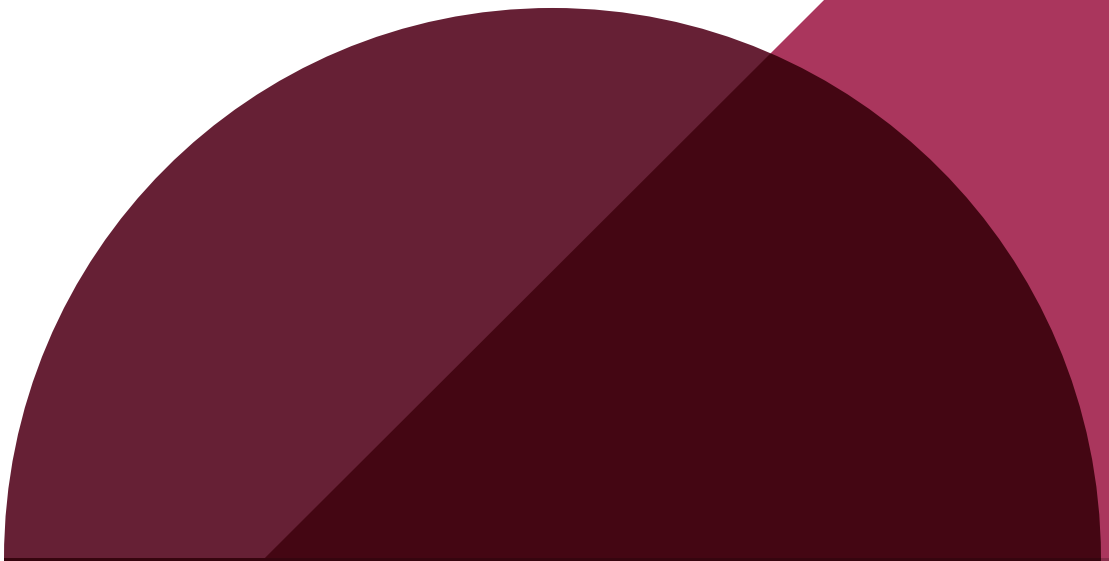
Directors' duties and liabilities in financial distress during Covid-19

July 2020



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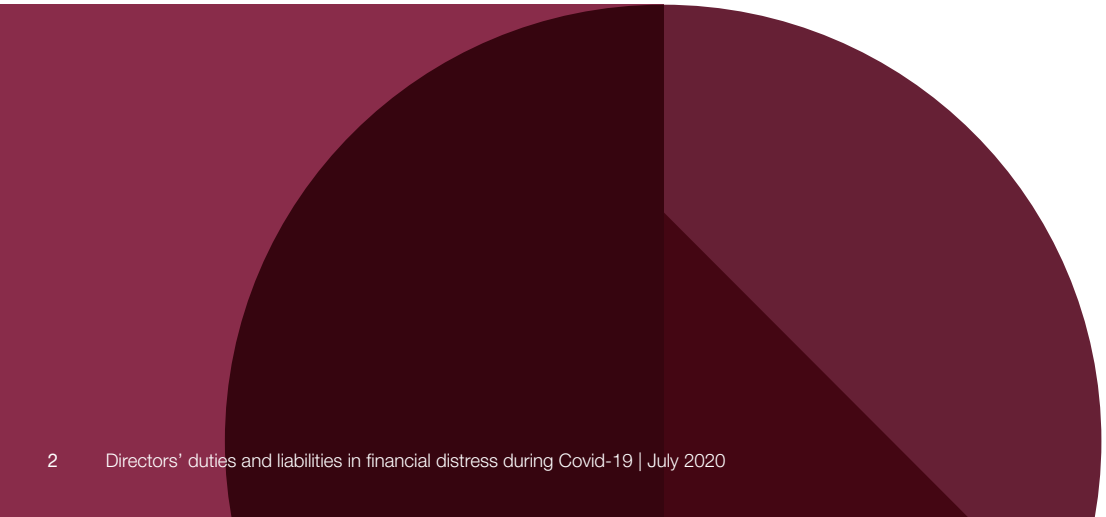
Directors' duties and liabilities in financial distress during Covid-19

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.

France

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?	Under French company law, the duty of loyalty requires directors to act in good faith and to put the interests of the company and its shareholders ahead of any other interests he may have. Directors have to above all act and make decisions in the company's interest. In this respect, French company law adopts a stakeholder approach and social interest includes the interest of the company, its shareholders, employees, clients and certain third parties and takes into account the social and environmental effects of the company's activity.

No.	Question	Answer
2.	What are the key areas of potential liability for directors when a company is in financial difficulties?	The risk depends on the level of difficulties the company is facing. – In general, the potential risks arise when directors do not file for bankruptcy within 45 days following the date on which the company becomes insolvent (as detailed in 9. below). – If the company is facing serious difficulties without being in cessation of payments, the directors can avoid liability by filing for a *mandat ad hoc* (amicable and speedy proceeding for companies not yet in cessation of payment) and ask the court's agent (*mandataire ad hoc*) to assist the company in the negotiations with its creditors. – If the company is in liquidation because of insufficient assets as a result of mismanagement by all or some of the directors, they can be (jointly or severally) liable for deficiency of assets, held criminally liable or even declared bankrupt/prohibited from managing a company by the Courts in case of fraudulent behaviour (as detailed in 12. below). A director (*de jure and de facto* as set out in 3. below) may also be sued on grounds of civil tort by the company (through the administrator). The conditions under which a director can be held liable vary for each of the grounds of liability listed above and detailed in 12. Since shareholders may also be considered as *de facto* managers, all the liabilities listed above can apply to shareholders in such capacity. In a group and despite the French law principle of separation of entities set out in 13, there is a risk that the company's administrator/liquidator could request the consolidation of the company's insolvency proceedings with another group member by demonstrating a commingling of assets (*confusion de patrimoines*). Another risk lies in the French law concept of co-employer. This is a strategy to make party to litigation a company which is not the formal employer but belongs to the same group, resulting in the joint liability of the two companies to pay the mandatory termination amounts to the employees and/or damages for unfair dismissal. Please note that directors' liability is significantly reduced when choosing to file for bankruptcy, by having the protection of the Courts as all payment post-filing must be co-signed by the administrator and the asset disposal must be authorised by the Courts.
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?	A de facto director may incur the same civil liability as the de jure director of a company (see question 11 infra). French law does not define the concept of de facto director, nor does it define the concept of "*de facto* management". These concepts have been developed under French case law and the characteristics of a de facto director are subject to the sovereign interpretation of French courts on a case-by-case basis. This quality is characterised by the free and independent exercise, either alone or in a group, on a continuous and regular basis, of positive management and leadership activities involving the company. The burden of proof is on the creditor.

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 of a company shall act diligently and in all circumstances in the best interest of the company. They will be liable in case of breach of duty of care or mismanagement. In particular they may be liable for operating a business which is loss-making or for having taken decisions which do not fit the corporate purpose or benefit of the company, aggravating its financial situation and eventually triggering its insolvency. In the event of liquidation proceedings (*liquidation judiciaire*), they may be held personally liable for all or part of the debts of the insolvent company if their mismanagement in the operation of the business contributed to the company having insufficient assets to cover its liabilities (see question 11 infra). Failing to establish the existence of a fault by the director, which is not committed in their capacity as a director, the wronged creditor may obtain compensation for their loss only by acting on the basis of the liability of the company. Only the company may be required to compensate the damage suffered by the creditor resulting from the non-performance of its contractual obligations.
5.	What are the liability risks in the case of 'creditor stretching'?	The same rule as discussed under 1. The mere fact that a director does not ensure compliance by the company with its payment obligations towards its creditors is not in itself sufficient to establish personal liability.
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?	In the event of insolvency proceedings: – the general principle is, during the proceedings, a prohibition on payment of existing debt, subject to certain exceptions; and – the proceeds of the realisation of the assets should be distributed among creditors on a *pari passu* basis by principle, subject to the statutory order of priority. In particular, the following claims will benefit from a preferential status: employees' wages, legal expenses incurred after the judgment commencing the insolvency proceedings, debts secured by new money privilege (i.e. new money provided by creditors at the time of a conciliation proceeding), claims of secured creditors with the benefit of mortgages/pledges, certain debts incurred by the company after the opening of the insolvency proceedings. A director may notably be subject to personal bankruptcy (as one of the possible sanctions against directors, amongst the ones mentioned in 11.) if he has deliberately paid any creditor of an ailing company after the date of the cessation of payments (*cessation des paiements*) as defined in 6. and caused damage to the other creditors. French law expressly provides that the Courts may declare personal bankruptcy of any person who has paid, or caused to be paid, a creditor to the prejudice of other creditors, after cessation of payments and with full knowledge of the company's situation. In that context, the Courts can indeed sanction a director that either has enriched themself at the expense of the company, or has seriously failed in their mission.

No.	Question	Answer
7.	Is there a distinction in this regard between preferential treatment of related entities and of other creditors?	The general principle is prohibition of any payment of existing debt except certain debts (employees' debts have a special status for example). Please refer to 3 but there should not be any compelling reason to give preferential treatment to related entities, except where the official receiver (*juge-commissaire*) authorises the debtor to pay prior debts, in order to release a pledge or to obtain the return of property and rights transferred as security in a trust, when such a release or return is justified by the continuation of the business.
8.	Is there an obligation in case of financial difficulties to convene a shareholders' meeting and. if so, at what stage of financial difficulties?	Unless provided in the articles of association, there is no obligation to convene a shareholders' meeting in case of financial difficulties. However, a voluntary liquidation can only be opened upon an extraordinary shareholders' resolution deciding on the dissolution of the company and appointment of a private liquidator.
9.	Is there an obligation at some stage to file for bankruptcy or other statutory insolvency protection regimes?	Under French law, a company is considered to be insolvent (*en état de cessation des paiements*) when it is unable to pay its debts as they fall due with its available assets, taking into account available credit lines and existing rescheduling agreements. This is a cash flow test. If the company is insolvent, its director must within 45 days following the date on which the company becomes insolvent either file for rehabilitation (*redressement judiciaire*) or liquidation proceedings or, if the company is insolvent for less than 45 days, conciliation (which are consensual/confidential proceedings not falling within the definition of "insolvency proceedings" within the meaning of the EU Insolvency Regulation). If the due date is violated, the legal representative is potentially exposed to various sanctions, including a prohibition on managing for up to 15 years. Please note that in order to avoid liability, directors will have to show that the insolvency is due to external causes and/or that they took every step they could to restructure the company such as filing for insolvency proceedings with the competent commercial court. Note that insolvency laws have been temporarily adapted in the context of the COVID-19 pandemic, including the following: until 23 August 2020, the solvency situation of companies is assessed as at 12 March 2020. This effectively means that the directors' obligation to file for insolvency is postponed until 23 August 2020 at the earliest if a cessation of payments occurred (as a matter of fact) between 12 March 2020 and 23 August 2020.

No.	Question	Answer
10.	Are there special liability risks in respect of certain debts, such as tax debts, social security payments, and pension contributions?	Where a company director is liable for the serious and repeated failure to comply with tax obligations which have made it impossible to collect taxes and penalties owed by the company, corporate body or group, such director may, where he is not already bound to pay the debts of the company by virtue of another provision, be declared jointly and severally liable for the payment of such taxes and penalties by the president of the court. Except in the case of serious mismanagement or a commitment as joint and several guarantors, the director is not personally liable, out of their own assets, for the payment of the company's debt in respect of social security contributions and late payment penalties. However, French case law shows that a director may be ordered personally to pay damages for the prejudice, distinct from that already compensated by the late payment penalties, caused to URSSAF (Union for the Collection of Social Security Contributions and Family Allowances) by the non-payment on time of the contributions, such as, for example, the costs incurred by the opening of a litigation file. Moreover, as a single unpaid creditor may be sufficient evidence of a cessation of payments situation, it is common for insolvency proceedings to be requested by a single creditor such as the tax authorities or URSSAF if the debtor fails to pay an instalment on one of these debts.
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?	All directors are jointly and severally liable for any fault or negligence of the board. Indeed, directors have no individual decision-making power over the affairs of the company, but rather the board of directors takes action collectively, as a group, and it only takes decisions through votes. The only exception to the directors' joint and several liability is where civil liability arises out of specific actions taken by an individual director. Each member may avoid liability by establishing that he or she has behaved as a prudent and diligent director or member of the management board, in particular by opposing the decision taken by the collegiate body.

No.	Question	Answer
12.	Are there specific actions against directors under bankruptcy law?	Under French bankruptcy law, directors of an insolvent company may incur the following civil or criminal liabilities: (a) Liability for deficiency of assets (*responsabilité pour insuffisance d'actifs*): in the event of liquidation proceedings, a director may be held personally liable for all or part of the debts of the insolvent company where (i) there are insufficient assets to discharge liabilities and (ii) there has been a mismanagement in the operation of the business committed by the director which (iii) contributed to the company having insufficient assets to cover its liabilities. Please note that, while the proceedings relating to deficiency of assets are ongoing, the President of the court may freeze the director's assets, as well as the shareholders' assets when such shareholders are jointly and indefinitely liable for the debtor's liabilities. (b) Personal bankruptcy (*faillite personnelle*) can be ordered by the Courts at any stage where a company is the subject of rehabilitation or liquidation proceedings, and a director may be liable for personal bankruptcy leading to (i) a prohibition on managing, operating or controlling, directly or indirectly, any business and (ii) a prohibition on accessing certain professional activities as well as a deprivation of certain civic rights. A director may notably be subject to personal bankruptcy if he has deliberately paid any creditor of an ailing company after the date of the cessation of payments (i.e. causing damage to the other creditors). (c) Criminal bankruptcy (*banqueroute*): a director may be guilty of criminal bankruptcy (notably if (i) he has bought goods in order to resell them below market price, or has used inappropriate methods to obtain funds, in each case with the intention of avoiding or delaying the commencement of appropriate insolvency proceedings for judicial reconstruction, (ii) he has kept false accounts or caused accounting documents of the business or the incorporated body to disappear or has failed to keep any accounts at all when the law required them to do so or (iii) he has kept accounts manifestly incomplete or incorrect in accordance with the law.)

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?	Financial difficulties do not trigger specific duties of, or consequences for, shareholders or group companies. However, shareholders or group companies acting as de facto directors may be sought to cover the insufficiency of assets in the event that they mismanaged the company and such mismanagement has contributed to the creation of an insufficiency of assets. French law does not recognise per se the concept of a "group" and directors must focus on the state of their own company and not on the group as a whole. However, French courts developed the concept of co-employment, used by claimants attempting to challenge collective redundancies carried out within a group, in particular if the employer of the employees is under insolvency proceedings. Pursuant to case law, the concept of co-employment applies where there was either (i) a subordinate relationship between the dominant company and the employees of the subsidiary; or (ii) a "confusion of interests, activities and management between different entities". That can be the case whenever one company has no independence regarding the management of its assets, its finance, accounts, or its human resources; or if its management consisted partially or entirely of the management of another company. Notwithstanding the principle of separation of entities set out above, the company's administrator/liquidator could request the consolidation of the company's insolvency proceedings with another group member by demonstrating as a matter of fact that assets/liabilities of the company are commingled ("*confusion de patrimoines*") with another (solvent) member of the group and that these two companies are in fact one single entity and that they cannot be dissociated.
14.	Is there special legislation mitigating the liability risks of directors specifically in view of the Covid-19 crisis?	No.

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