ALLEN & OVERY

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

July 2020

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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.

Luxembourg

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?	Under Luxembourg company law, directors must act in the corporate interest of the company. While the exact width of this notion is debated in the Luxembourg legal doctrine, the prevailing view is that the board of directors, in doing so, must exercise due care towards the interests of the company's stakeholders such as its shareholders, employees, trade partners and creditors. The more a company gets into financial distress, the more the board of directors' duty of care arguably shifts from the wider group of stakeholders, including shareholders, to the narrower group of creditors (including employees and debt providers). If there is no more 'light at the end of the tunnel', shareholder value has evaporated and the focus must be on the interests of the creditors.
2.	What are the key areas of potential liability for directors when a company is in financial difficulties?	Under Luxembourg law, a company, its shareholders and third parties can invoke different legal grounds to trigger directors' liability. Vis-à-vis the company, directors face liability in the event of mismanagement, a breach of the 1915 Law on commercial companies (the **1915 Law**) or the company's articles of association. Third parties are entitled to rely on a breach of the 1915 Law or the company's articles, in addition to liability in tort, to trigger directors' liability. **1. Mismanagement:** directors are individually liable towards the company for the performance of their mandate and any misconduct in the management of the company. Mismanagement is a fault-based concept. Directors commit mismanagement if their action or inaction can be characterised as deviating from the behaviour that would have been adopted by a normally prudent director. In other words, directors are expected to choose a course of action that a normally prudent director would choose in similar circumstances, including if the company is in financial difficulties.

<table>
<tr><th>No.</th><th>Question</th><th>Answer</th></tr>
<tr><td></td><td></td><td>Examples of actions or inactions that have resulted in mismanagement, which are particularly relevant if the company is in financial difficulties, include:
– Entering into contracts to the disadvantage of the company
– Failing to collect receivables that are due and payable or waiving them
– Paying a debt that is not due
– Failing to inform the shareholders of the actual (financial) situation of the company
– Not attending board meetings

If the company is in financial difficulties, directors should also pay extra attention to intra-group transactions, as they need to make sure that such intra-group transactions are in the company's corporate benefit.

2. Breach of the 1915 Law and the company's articles: directors are jointly and severally liable in the case of breach of the 1915 Law and the company's articles (with the possibility for individual directors to exculpate themselves in certain circumstances). This includes liability for damages sustained by third parties due to the breach of the regulations on annual accounts or in the case of payment of fictitious dividends.

3. Tort: directors can also be liable in tort vis-à-vis third parties who can prove that the director's misconduct is personal. In addition, case law has set that third parties need to demonstrate that the misconduct is detached from the director's functions, which makes third parties' liability claims difficult to prove in most circumstances.</td></tr>
<tr><td>3.</td><td>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?</td><td>If an officer, shareholder or other person who has not been appointed as a director commits factual acts of management, such 'de facto' or 'shadow' director can be subject to and face some of the legal duties, responsibilities and liability as a formally appointed director. That person is deemed to be a 'de facto director' if they commit such acts (i.e. positive actions) relating to management matters in place of the formally appointed directors or if they have been instructed by the appointed directors to act in a certain manner. This assessment is mainly a factual question, whose burden of proof is on the relevant interested party (such as creditors).</td></tr>
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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 may be held liable if they enter into new obligations on behalf of the company when, at that time, they knew or should have realised that the company would not be able to fulfil those obligations and that the company would be unable to pay the resulting claim for damages (no 'light at the end of the tunnel'). In that case, directors can be *inter alia* held liable, generally at the initiative of the bankruptcy receiver, if their action (or omission) can be characterised as mismanagement (see above). In addition, directors can be held liable in the event of bankruptcy if they committed serious faults that contributed to the company's bankruptcy, e.g. if they entered into an agreement completely out of proportion with the company's financial position (and leading to its bankruptcy). Lastly, directors can be held personally liable in the case of wrongful trading conduct for their own benefit (see below). If there is no 'light at the end of the tunnel', directors will also have the obligation to file for bankruptcy (in normal times: cf. below for the specific measures adopted in light of the Covid-19 outbreak), i.e. when the company has (a) ceased its payments and is unable to meet its commitments (*cessation de paiements*) and (b) lost its creditworthiness (*ébranlement de crédit*), e.g. cannot obtain liquidities or arrange debt rescheduling with its creditors (the **Bankruptcy Conditions**). We refer to question 9 for further developments on the duty of directors to file for bankruptcy.
5.	What are the liability risks in the case of 'creditor stretching'?	Liability resulting from creditor stretching should be analysed on a case-by-case basis and depends on factual circumstances. As set out above, and assuming that the company has not yet met the Bankruptcy Conditions, creditor stretching is not as such sufficient to trigger a personal liability of the directors as such tactic could – in certain instances – save the company from bankruptcy: delaying of payments could for instance be used as a way to secure a refinancing. If, on the other hand, only related parties' debt is paid in time (and the debt of all external creditors is stretched) or if it was evident that the company could not have access to the financing (or debt rescheduling) necessary to survive, liability of the directors might be triggered in the case of bankruptcy.
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 there are insufficient funds available to pay all creditors, and without prejudice to subordination and security-related arrangements, companies are entitled to pay those creditors that are key for the company's short term survival (employees, certain suppliers) and delay payment to others, as long as there is a credible perspective of a refinancing/survival (and the Bankruptcy Conditions are not met). If there is no such 'light at the end of the tunnel' anymore, the company and its directors should aim for equal treatment of (unsecured) creditors. In the short interval prior to such bankruptcy declaration, selective payments should then only be made to imminent creditors and if there are compelling grounds to do so, such as preserving value in the company's assets for the benefit of all creditors. Directors should also take into account the clawback period provided by the Luxembourg Commercial Code: indeed, certain payments made (or transactions carried out) as listed in the Commercial Code (e.g. payment of debts which have not fallen due, transactions not at arm's length/with no or materially undervalued consideration, payments of matured debt if they were accepted with the knowledge of the company's cessation of payments, etc.) during a period of six months and ten days prior to the bankruptcy adjudication by the Commercial Court can be cancelled (upon proceedings initiated by the bankruptcy receiver).

No.	Question	Answer
7.	Is there a distinction in this regard between preferential treatment of related entities and the treatment of other creditors?	The same rule as discussed under 6. will apply, but case law shows that courts may not easily be convinced that there was a compelling reason (in the interest of the company and its creditors) to give a preferential treatment to related entities.
8.	Is there an obligation in case of financial difficulties to convene a shareholders' meeting and. if so, at what stage of financial difficulties?	Yes. If the net assets of a public limited liability company (*société anonyme*) have fallen below 50% of the share capital, the board of directors has an obligation (within two months from the date such losses were or should have been assessed) to convene a shareholders' meeting. Such meeting will resolve either (a) to dissolve the company (for a public limited liability company, with a quorum of 50% and majority of ¾) or (b) to continue the company's activities. The same obligation occurs when the company's net assets have fallen below 25% of the share capital, except that the dissolution only requires a ¼ majority. Articles of association can provide stricter thresholds than those set out above. Directors may face joint and several liability towards the Company for any increase of the loss suffered by the company after the date on which they should have convened the shareholders' meeting.
9.	Is there an obligation at some stage to file for bankruptcy or other statutory insolvency protection regimes?	Yes. Directors have the obligation to acknowledge and file for bankruptcy (aveu de faillite) with the Commercial Court within one month from the date on which the company has ceased payments under the Bankruptcy Conditions (subject to criminal sanctions). However, in the context of the Covid-19 outbreak, the Luxembourg Government adopted a Grand Ducal Regulation providing for the suspension of such obligation, initially until the end of the state of crisis, i .e. on 24 June 2020. The suspension of this obligation has been extended for an additional period of six months as from the date of the end of the state of crisis.
10.	Are there special liability risks in respect of certain debts, such as tax debts, social security payments, and pension contributions?	Yes, with respect to tax debts. Directors are responsible to ensure that all tax obligations and duties relating to the company are duly complied with. Directors may be held jointly and severally liable if the tax administration can prove that the failure to comply with tax obligations is due to the directors' wrongful misconduct (*inexécution fautive*). Such assessment is based on factual circumstances and the mere fact that the company does not pay its tax debts is not sufficient as such to conclude to directors' wrongful misconduct. If successful, the tax administration can issue a notice of secondary recourse (*appel en garantie*) against the directors.

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 are individually liable in the case of mismanagement (unless the wrongful action is common/joint, in such case there will be joint and several liability between the directors), jointly and severally liable in the event of a breach of the Companies Act or the company's articles of association and severally (or, as the case may be, severally and jointly) in the event of serious mismanagement that has contributed to the bankruptcy of the company. In a nutshell, where the liability is not individual, board members can exonerate themselves if they can evidence that such directors (i) did not take part/contribute to the wrongful action (or omission), (ii) actively distanced themselves from such fault and (iii) disclosed such wrongful action (or omission) at the next general meeting.
12.	Are there specific actions against directors under bankruptcy law?	Yes. Formally appointed or *de facto* directors can be held (either severally or jointly and severally) liable for all or part of the company's debts if they committed serious faults that contributed to the bankruptcy of the company (e.g. entering into out-of-proportion agreements). If held liable, an additional sanction that could be imposed upon such directors is the prohibition on practising trade or having a directorship's mandate. In exceptional circumstances, the bankruptcy can be extended to directors (who can be personally declared bankrupt, together with the company in order to constitute one single bankruptcy estate) if such directors (i) have entered into commercial transactions for their benefit, acting under the corporate veil, (ii) disposed of assets as if they were their own or (iii) have pursued, in their own interest and in an abusive manner, a loss-making business that was bound to lead to insolvency.
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?	In limited liability companies, financial difficulties as such do not trigger specific duties of, or consequences for, shareholders or group companies. Shareholder receivables will not automatically be subordinated. However, a shareholder may be liable in exceptional circumstances if (i) it is considered as a *de facto* director (as set out above) or (ii) a court were to pierce the corporate veil (i.e. if the company has no separate economic existence from the shareholder – this will be a factual assessment based *inter alia* on various factors, such as intermingling between assets of the shareholder and subsidiary, important management decisions are taken by the shareholder (and not by the board)).
14.	Is there special legislation mitigating the liability risks of directors specifically in view of the Covid-19 crisis?	Yes – cf. above as to the suspension of the obligation for the directors to file for the bankruptcy.

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CS2007_CDD-60420_ADD-91019