

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

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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

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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

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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.



# Russia

No.	Question	Answer
<b>Directors' Duties</b>		
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?	<p>The Russian Civil Code and laws on joint-stock companies and limited liability companies impose on the chief executive officer (the <b>CEO</b>) or multiple general directors, the management company, a member of the board of directors or the management board of a Russian company (each, a <b>director</b>) the obligation to act reasonably and in good faith in the interests of the company and its shareholders. A director can be held personally liable for damages caused by breaching this obligation. A director also has to ensure that the company complies with its obligations to its creditors and employees.</p> <p>When a company finds itself in financial difficulties (either insolvent or likely to become insolvent (has signs of insolvency)), all directors, shareholders and other "controlling persons" of the company are obliged to act in the interests of the company's creditors (including employees and debt providers) from the day they knew or should have known about the signs of insolvency of that company.</p>



No.	Question	Answer
2.	What are the key areas of potential liability for directors when a company is in financial difficulties?	<p>If a director breaches any of its general duties, it may:</p> <ul style="list-style-type: none"> <li>(i) be held personally liable to compensate the company or (in very rare cases) its shareholders and/or third parties for losses caused as a result of the breach, provided that the director was at fault; and/or</li> <li>(ii) become subject to employment liability where the director is an employee of the company (i.e. the members of the board of directors are not subject to employment liability); or</li> <li>(iii) become subject to administrative or criminal liability (where the director's action or omission constitutes a particular administrative or criminal offence).</li> </ul> <p>The CEO, general director or shareholder (the <b>participant</b>) may be held criminally liable under the Russian Criminal Code for:</p> <ul style="list-style-type: none"> <li>(i) intentionally taking (or failing to take) steps which led to the inability of the company to satisfy the monetary claims of its creditors or make mandatory payments in full if such actions or omissions resulted in serious damage; or</li> <li>(ii) making a fraudulent public declaration of the company's bankruptcy.</li> </ul> <p>Administrative sanctions may be imposed particularly for the following actions both before and during bankruptcy proceedings: (a) withholding, concealing, transferring or destroying assets or information on the assets of the company, falsifying accounting documents when the company displays signs of insolvency; (b) illegal satisfaction of creditors' claims with knowledge that such satisfaction is prejudicial to other creditors; (c) failure to file a bankruptcy petition by the CEO or general director; (d) illegally impeding the activities of the arbitration manager; and (e) failure to comply with the final court's ruling on subsidiary liability of a "controlling person" for the debts of the company.</p> <p>The consequences of administrative and criminal liability may include: dismissal, disqualification, fines or imprisonment.</p> <p>There is also a subsidiary liability of a "controlling person" of a company for the debts of that company if the inability of the company to satisfy all creditors' claims in full occurred as a result of actions (or inactions) of that "controlling person". For more details see answer under 3.</p>



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>Any person having the authority to determine the actions of the company, including the ability to give instructions to the directors of the company, is liable for any damages incurred by the company due to that person's fault.</p> <p>There is also a concept of "controlling person" under Russian insolvency laws. A "controlling person" is a person or an entity which has, or had during the three-year period before the bankruptcy conditions actually occurred and, following that, before the acceptance by a court of the bankruptcy petition: (a) the right to give binding instructions to the company; or (b) the ability to determine the actions of the company (due to the associated ties with, or holding an official position in, or being a representative of, the company, or for any other reason (including applying force or pressure to the officials or governing bodies of the company)). The CEO, general director, chief accountant, financial director and any member of a governing body of the company, the parent company of that company or any of its officials or any beneficiary of any illegal actions of the company are presumed to be the "controlling persons" of the company, unless the relevant defendant proves otherwise. A court may also identify any other person as a controlling person based on any other proven ground (including classmates, co-habitants, long-term co-workers, etc.).</p> <p>A "controlling person" of a company bears subsidiary liability for the debts of that company if the inability of the company to satisfy all creditors' claims in full occurred as a result of actions (or inactions) of that "controlling person". A "controlling person" of a company could also be held liable for damages caused by its actions.</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 a director's duty to take the company's financial position into consideration under Russian insolvency laws. A director (acting always within the scope of its powers) must prevent the company from carrying on trading or otherwise increasing its debts, unless there is no doubt that the company will be able to meet those debts and will continue to be solvent. Where a director anticipates or ought to anticipate the insolvency of its company and during the various insolvency procedures, it is expected to take special care when authorising any transaction. Any transaction involving borrowing new money or providing new security in the situation of financial difficulties for the company could be potentially challenged as a preferential or suspicious transaction and cause the relevant directors to be held liable. For more details see answers under 6.</p>
5.	What are the liability risks in the case of 'creditor stretching'?	<p>The mere fact that a director of a company does not ensure that the company complies with its (payment) obligations towards its creditors is not in itself enough to establish personal liability. "Creditor stretching" as a way to gain time for a refinancing will not typically lead to personal liability. The analysis, however, is very much dependent on the circumstances. If only some creditors are stretched but debts to other creditors are paid on time, this could result in the preferential satisfaction of certain creditors' claims and result in directors' liability.</p>



No.	Question	Answer
6.	<p>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>	<p>In the case of financial difficulties, the company and its directors should aim for equal treatment of creditors. A director should bear in mind that any such selective payment could be challenged and reversed, should the bankruptcy proceedings commence, as a preferential or suspicious transaction and result in that director being held personally liable. In the short interval prior to the commencement of the bankruptcy proceedings, selective payments should only be made if there are compelling grounds to do so, such as preserving the value in the company's assets for the benefit of all creditors.</p> <p>A director may be held in breach of its duties if it authorises (or enters into on behalf of the company) a transaction that is subsequently reversed because it is found to have been:</p> <ul style="list-style-type: none"> <li>(i) preferential (i.e. to have resulted in the preferential satisfaction of the claims of particular creditors in the form of granting new security for existing obligations, changing the order of priorities for the satisfaction of creditors' claims, resulting, or possibly resulting, in the satisfaction of unmatured claims of certain creditors when unsatisfied matured claims of other creditors exist or conferring a preference in the satisfaction of a creditor's claims when compared to the order of the established priority), if it was concluded within a period of up to six months before the acceptance by a court of a bankruptcy petition or at any time after its acceptance; and</li> <li>(ii) suspicious ((a) effected at an undervalue (if concluded within a one-year period before the acceptance by a court of a bankruptcy petition or at any time after its acceptance); or (b) otherwise detrimental to the company's solvency (if concluded within a three-year period before the acceptance by a court of a bankruptcy petition or at any time after its acceptance)).</li> </ul>
7.	<p>Is there a distinction in this regard between preferential treatment of related entities and the treatment of other creditors?</p>	<p>See answers under 4 and 6.</p>



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?	No, unless there are specific provisions in the charter or other internal regulations of the company to that effect.
9.	Is there an obligation at some stage to file for bankruptcy or other statutory insolvency protection regimes?	<p>The CEO or a general director of a company is obliged under Russian insolvency laws to initiate bankruptcy proceedings by filing a compulsory bankruptcy petition within one month of the following becoming evident or occurring: (a) the amount of the company's debts exceeds the value of its assets (<b>balance sheet test</b>); (b) the company fails to make payments because it has insufficient funds (<b>cash flow test</b>); (c) satisfying claims of one or more creditors may result in the company's inability to satisfy claims of all creditors; (d) the enforcement of claims against the company's assets will result in significant difficulties for the company in continuing its operations; (e) the company's shareholders instruct the CEO to file a bankruptcy petition; or (f) salaries or wages due to employees or former employees are overdue for over three months.</p> <p>The CEO or a general director of a company is liable for any delay in the filing of a bankruptcy petition as well as for any wrongful filing (i.e. filing when the company was capable of satisfying all creditors' claims). If a delay in filing of a bankruptcy petition by the company was caused due to the actions of the CEO or a general director, they bear subsidiary liability for the obligations of the company that arose after the date when such filing should have been made.</p>
10.	Are there special liability risks in respect of certain debts, such as tax debts, social security payments, and pension contributions?	Yes. The CEO or a general director of the company and, in certain cases, the chief accountant and other responsible officers of the company could bear administrative and criminal liability for non-payment, late payment or miscalculation of due taxes and social security payments. In case of criminal liability, the criminal intention of the responsible person needs to be proved. In addition to that, the CEO or a general director may be required to reimburse the damages suffered by a company caused by their misconduct.





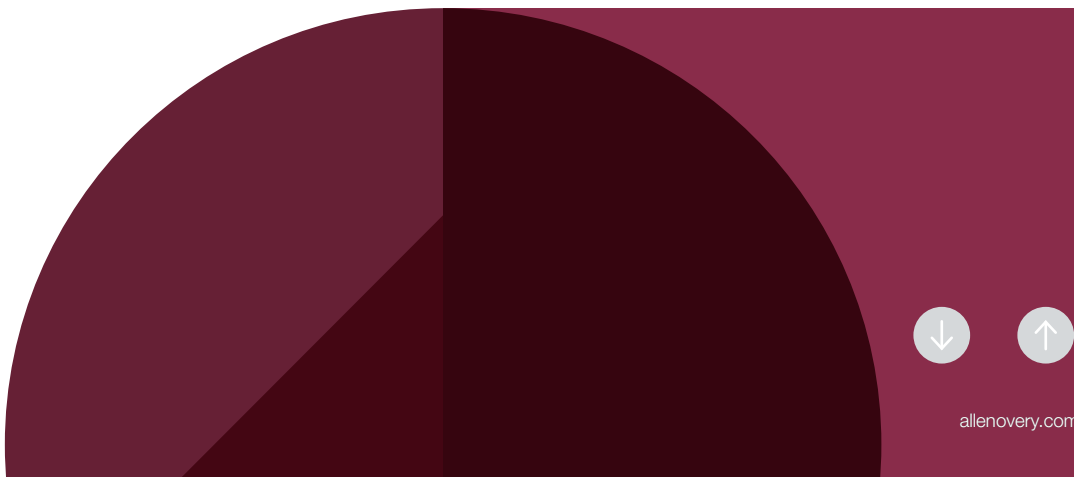
No.	Question	Answer
11.	Are the liability risks of the directors collective (i.e. the whole board is responsible/liable) or individual? On what grounds can a director exculpate themselves from other directors' acts or omissions?	<p>As a general rule, a director is solely liable for that director's wrongful acts and omissions. However, if the company's damages are caused by the joint actions of several directors, their liability is joint and several.</p> <p>According to existing court practice, a director can be exculpated from other directors' acts or omissions and should not be held liable:</p> <ul style="list-style-type: none"> <li>(i) if that person was the CEO or a general director and refused to execute the loss-making transaction;</li> <li>(ii) if that person was a member of a collective governing body of the company and voted against a resolution to approve a loss-making transaction or abstained from voting, acting in good faith;</li> <li>(iii) in case of a conflict of interest, if the conflicted director disclosed the conflict in advance of entering into the unprofitable transaction and the latter was approved in accordance with established corporate procedure;</li> <li>(iv) in case of an "unfavourable" transaction, if a director could prove that: (i) such transaction was a part of a number of interrelated transactions that, taken together, would benefit the company; or (ii) such transaction was made to prevent a greater loss to the company; or (iii) that director acted in the best interests of the company (which would not be the case if the director was acting in the interests of one or several shareholders to the company's detriment); and</li> <li>(v) in case of liability for tax or other offences by the company, if a director could prove that that director's actions does not constitute an offence under the law in effect at that time, inter alia, for lack of a consistent interpretation of the law.</li> </ul>



No.	Question	Answer
12.	Are there specific actions against directors under bankruptcy law?	<p>Yes, in a bankruptcy each “controlling person” of a company, including directors, bears joint and several secondary (subsidiary) liability for the debts of that company if the inability of the company to satisfy all creditors’ claims in full occurred as a result of actions (or inactions) of that “controlling person”. A “controlling person” of a company could also be held liable for damages caused by its actions.</p> <p>The guilt of a “controlling person” is presumed if: (i) the detriment to creditors’ rights occurred as a result of any transaction(s) (including suspicious or preferential transactions) concluded by, in favour of, or approved by, such “controlling person”; (ii) certain obligatory accounting documents are missing or falsified (the second criterion relates only to the controlling persons responsible for the maintenance of such accounting documents in order); and (iii) the company or its CEO or a general director was found liable for an administrative, tax or criminal offence and the amount of the claims of third-order creditors caused by such offence exceeds 50 per cent of the total amount of the third-order creditors’ claims registered with the relevant register (the third criterion relates only to the CEO or a general director of the company at the time of the offence).</p> <p>A “controlling person” can be absolved from liability if it proves its innocence or if it acted in good faith and reasonably in the interests of the company. Alternatively, a court may reduce the amount for which a “controlling person” is liable if the detriment caused by them is significantly smaller than the amount claimed.</p> <p>The petition on liability of a “controlling person” could be filed with a court during the bankruptcy management of the company within one year of the petitioning person knowing, or should have known, about the grounds for such claim and within three years of the company declaring bankruptcy, but in any case, before the bankruptcy proceedings are finished. Unlike with the subsidiary liability, in practice, a claim for reimbursement of damages by “controlling persons” could be filed even after the bankruptcy proceedings are finished.</p>



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?	<p>The Russian insolvency laws impose a duty on the company’s shareholders (owners) to undertake measures to restore the solvency of that company. The insolvency law does not provide an exhaustive list of such measures but it specifies that financial aid, in the amount sufficient to restore a company’s solvency, might be regarded as one such measure. It is worth mentioning that despite the existence of this duty, the insolvency law is silent on any corresponding liability for its breach.</p> <p>Shareholders’ claims to the company (as well as claims of other “controlling persons” or affiliates of the company) do not automatically become subordinated to the claims of other independent creditors in the course of bankruptcy proceedings of the company. However, according to recent court practice and clarification by the Russian Supreme Court, the claims of the “controlling persons” or affiliates of the company are likely to be subordinated by the courts if such claims are based on the financial aid (in the form of direct financing, additional security, rescheduling of debt, acquisition of the company’s debt from an independent creditor or repayment of the company’s debt to an independent creditor) provided to the company by the relevant “controlling persons” or affiliates where the company is in the situation of financial distress as a compensatory financing (with the aim to postpone bankruptcy proceedings). The burden of proof that the transaction in question was concluded within market conditions is upon the relevant “controlling person” or affiliate.</p>
14.	Is there special legislation mitigating the liability risks of directors specifically in view of the Covid-19 crisis?	Yes. With the aim to protect the business sector during the Covid-19 pandemic, starting from 6 April until 6 October 2020, the Russian Government introduced the insolvency moratorium regime in respect of companies operating in the hardest-hit industries, as well as systemically important and strategic enterprises (other than those specifically opting out of the insolvency <b>moratorium regime</b> ) (the moratorium debtors). During the insolvency moratorium period the obligation of a moratorium debtor and its directors to make a bankruptcy filing with an arbitrazh court (if there are signs of an insolvency) being suspended.



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