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

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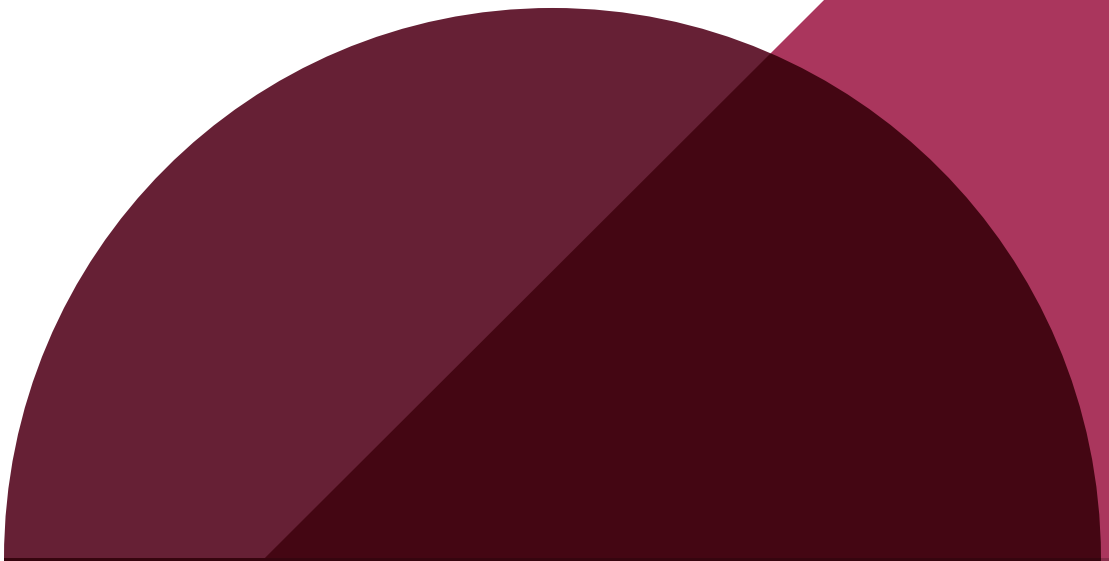

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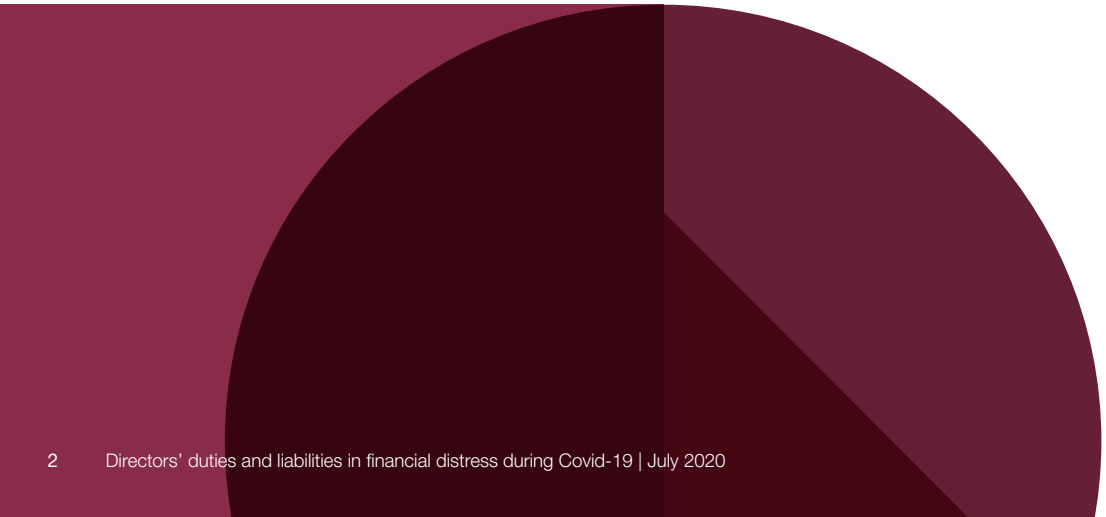
Directors' duties and liabilities in financial distress during Covid-19

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.

Slovakia

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 Slovak law, the general duty of loyalty provides for an **obligation to perform managerial functions in the best interest of the company and all its shareholders**. The provision is based on the premise that the interests of all shareholders and the interests of the company as a separate legal entity are aligned. That being said, the interests of the company and its shareholders may in particular cases differ (e.g. shareholders may not be interested in repaying the creditors of the company). The law then further elaborates that in performing their functions the directors may not put (i) their own interests, (ii) the interests of only some of the shareholders, or (iii) the interests of third parties, before the interests of the company. The law does not specify that the interests of other company's stakeholders (e.g. creditors or employees) should be followed. The criteria are not necessarily quantitative or prima facie financial. The best interests of the company can be ascertained by reference to various criteria, for example the aims with which the company was established, its shareholder structure and its short- and long-term business plans. In order to ensure this, directors must also necessarily take into account the interests of other stakeholders such as employees, trade partners and creditors, provided that they are compatible with the interests of the company. In general, in cases of financial distress, the above regime does not change and the directors' duties towards the company are even amplified. The specific regime under Slovak law applies if the company is in crisis (i.e. if the company is insolvent or at risk of insolvency). In that case, it is prohibited to make any repayments of loans or other obligations towards related parties so the focus of the company naturally shifts towards its creditors. If the company makes such repayment, it must be returned as unjust enrichment and directors are in a position of joint and several guarantors for return of such repayments. If the company enters into formal insolvency proceedings, the interests of its creditors have absolute priority.

No.	Question	Answer
2.	What are the key areas of potential liability for directors when a company is in financial difficulties?	In general, directors are liable for damage caused to the company as a result of a breach of their duties, whether in cases of financial distress or not. For the liability to arise there has to be (i) a breach of a duty under the law or incorporation documents of the company; (ii) damage incurred by the company; and (iii) a causal link between the breach and the damage incurred by the company. A breach of duty can be based on a director's action or omission. The breach does not require a culpable act (i.e. negligence or intent of a director). The law provides for a rebuttable legal presumption that a director has breached their duties. This means that unlike in standard damage claims, where the claimant would bear the burden of proof regarding the breach, **in the event of a breach of duties the burden of proof rests on the director, who must substantiate that the duties were not breached**. There are several legal provisions that create directors' liability in the case of financial distress. For instance, if a director found out or, considering all circumstances, could find out that the company is in crisis (i.e. if the company is insolvent or at risk of insolvency), the director is obliged to procure all reasonably necessary steps to overcome the crisis. Further, directors may not distribute dividends or other distributions to shareholders if, considering all circumstances, it causes insolvency of the company and the company's equity to be lower than its share capital plus reserve funds. Furthermore, there are a number of other cases of specific personal liability of directors which are discussed in the following parts of this survey.
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?	In general, the liability rests mainly on formally appointed directors. However, there are some nuances outlined below. If a shareholder, or another person who has not been formally appointed as a director, commits factual acts which fall within the competence of a director, they are liable on the same footing as a director for such acts as a 'shadow director'. The person is deemed a 'shadow director' if they commit acts to the same extent that a director has the authority to perform in all areas of the company's management on a regular basis. Therefore, if, for example, a person is entrusted with a certain line of business management (authorized employee, manager), or is authorized to perform actions on behalf of the company, such person will not be automatically deemed a 'shadow director'. In this regard, the position of shareholders as controlling persons is also relevant, as further discussed under 13 below.
4.	What are the standards for directors' liability for the company having entered into contracts that the company can later not perform ('wrongful trading')?	If such acts would be performed in breach of duty of care or duty of loyalty, cause any damage to the company and, potentially, subsequent damage to creditors, a director would be potentially liable under general provisions on director's liability described under 2 above (not only to the company and its shareholders, but also to the creditors) and possibly for breach of their specific prevention duty under bankruptcy law as described under 12 below.

No.	Question	Answer
5.	What are the liability risks in the case of 'creditor stretching'?	There is no specific liability regime for this situation, but the general directors' liability (section 2 above) and insolvency-related liability applies. The mere fact that a director does not ensure that the company complies with its obligations towards its creditors does not in itself create personal liability of directors involved. Having said that, if the company gets into default with its obligations towards creditors, even if such obligations could have been duly and timely satisfied, directors taking such decision to delay payments to the creditors may be potentially liable for damage caused to the company as a result of such default (e.g. by obligation to pay default interest, contractual penalty, etc.). This would very much depend on whether directors acted in certain circumstances with due care or not.
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?	Apart from potential liability discussed under 5 above, in general, making selective payments to creditors does not in itself create personal liability of directors, if it is to a certain degree beneficial for the company and only in cases where the company is not at the stage of crisis or bankruptcy as described below. If the company gets into the stage of bankruptcy, any preferential treatment of certain creditors is prohibited and directors have the obligation to file for bankruptcy within a certain deadline, as described in 9 below. Furthermore, such selective treatment of some creditors at the stage of bankruptcy may even have consequences under criminal law.
7.	Is there a distinction in this regard between preferential treatment of related entities and the treatment of other creditors?	The same applies as discussed under 6 above. In addition, if the company gets into crisis (i.e. if the company is insolvent or at risk of insolvency), there is a specific prohibition to make any repayments towards related parties, as discussed under 1 above.
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 company's loss has exceeded the value of one-third of the company's share capital, however, this applies only to directors of a Slovak joint-stock company. In addition, members of the Supervisory Board of a Slovak joint-stock company or limited liability company are obliged to convene a shareholders meeting if the interests of the company so require, which will most likely apply also to cases of financial difficulties. Furthermore, a general obligation to convene a shareholders meeting in case of financial difficulties may also derive from the general duty of care of all directors of the company, provided that such shareholders meeting is necessary in terms of solving such financial difficulties.

No.	Question	Answer
9.	Is there an obligation at some stage to file for bankruptcy or other statutory insolvency protection regimes?	Yes, a director is obliged to file for bankruptcy within 30 days after a director finds out that the company is overindebted (i.e. the value of liabilities exceeds the value of assets of the company). If a director fails to file for bankruptcy within the set deadline, they are obliged to pay to the company a penalty of EUR 12,500. Furthermore, this does not prevent the company from claiming any damages exceeding this penalty.
10.	Are there special liability risks in respect of certain debts, such as tax debts, social security payments, and pension contributions?	There are no specific liability risks in this regard in terms of civil law or administrative requirements. However, non-payment of due taxes, social security payments or similar contributions may potentially, under certain circumstances, create criminal liability of the company and its directors, in particular, if the company was solvent at the time when such contributions became due.
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 involved in an action are liable jointly and severally towards the company. Joint and several liability means that the company may seek full compensation from any or all of the directors involved, irrespective of their individual level of involvement, and each liable director has the obligation to provide the full amount of the compensation. If damage occurred as a result of a collective decision of all directors, all directors who voted in favour of the decision would be jointly and severally liable for its compensation. However, this does not mean that the directors that did not vote in favour of the decision are automatically relieved of liability. Their liability will be assessed in a broader context of all their previous and subsequent actions and omissions that could have contributed to or prevented the damage. E.g. if one of the directors clearly flagged at the relevant board meetings or communicated towards shareholders inappropriate or disadvantageous actions (detrimental to the company) and was not involved in resolving on or implementation of that action, they would have good grounds for exculpation.
12.	Are there specific actions against directors under bankruptcy law?	Yes. The general prevention duty under Slovak bankruptcy law provides for an obligation of each director to (a) constantly monitor the development of the company's financial situation, as well as the state of its assets and liabilities, and (b) take appropriate and proportionate measures to avert bankruptcy of the company. If not, a director is liable for any damage caused to the company under general director's liability provisions under Slovak company law. In addition to the liability towards the company as described under 9 above, a director who fails to file for bankruptcy within 30 days after they find out that the company is overindebted, is liable for any damage caused to the company's creditors by such late filing for bankruptcy.

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?	A controlling person (i.e. a shareholder with direct or indirect voting majority in the company) is liable towards the company's creditors if such controlling person significantly contributed to the bankruptcy of the company. The controlling person may be relieved of this liability if it proves that it acted in an informed manner and in good faith and that it is acting in favour of the company. In addition, direct or indirect shareholders may be liable towards the company as shadow directors, as described under 3 above. The specific regime under Slovak law applies if the company is in crisis (i.e. if the company is insolvent or at risk of insolvency). In that case, it is prohibited to make any repayments of loans or other obligations towards related parties so the focus of the company naturally shifts towards its creditors. If the company makes such repayment, it must be returned as unjust enrichment and directors are in a position of joint and several guarantors for return of such repayments. Furthermore, at the stage of formal insolvency proceedings, receivables towards related parties are subordinated by operation of law, and can be satisfied only after the satisfaction of all other creditors.
14.	Is there special legislation mitigating the liability risks of directors specifically in view of the Covid-19 crisis?	No.

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