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.

The Netherlands

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 Dutch company law, directors must focus on the 'enduring (i.e., not just short term) success' of the company and the enterprise attached to it and, in doing so, must exercise due care towards the interests of the company's stakeholders such as its shareholders, employees, trade partners and creditors and, to some extent, society at large. The interests of those stakeholders may not be harmed disproportionately or unnecessarily. The more a company gets into financial distress, the more the management board's duty of care shifts from the wider group of stakeholders, including shareholders, to the more narrow 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.

No.	Question	Answer
2.	What are the key areas of potential liability for directors when a company is in financial difficulties?	There is a distinction between the internal and external liability of managing directors. Contractual liability exists vis-à-vis the company and arises from the contractual and corporate relationship between the managing directors on the one hand, and the company on the other hand. Internal liability is in principle a collective liability of the management board (with the possibility for individual directors to exculpate themselves). External liability is an individual liability of managing directors towards third parties, such as creditors, individual shareholders, employees and the tax authorities. In recent case law, the Dutch Supreme Court brought the various liability standards close to each other. With the exception of a number of specific legal provisions that create a quasi-strict liability (some of which are discussed below), a managing director is only liable, both internally and externally, if he can be made the subject of a 'serious reproach'. This threshold in all cases is high. Examples from (higher and lower courts) law of actions that have resulted in internal and/or external liability of managing directors include: – to enter into agreements on behalf of the company while knowing that the company will be unable to meet its obligations; – to procure without proper justification that the company does not meet an agreement, while it is foreseeable that this would result in damage to the opposite party; – to take major risks unnecessarily and make a rash assessment, from an economic standpoint, of the value of acquisitions, or to otherwise make important decisions without proper information/investigation; – to mingle private affairs with those of the company and/or appropriate corporate opportunities; – to frustrate recourse by splitting up a company into viable and nonviable units; – to use deducted pension premiums for business operations. There are a number of legal provisions that create liability for managing directors even if they do not act (seriously) in a way which is reproachable, some of which are discussed below. Each managing director is, for instance, in principle jointly and severally liable for damage sustained by third parties due to misleading statements in the annual accounts of the company. For BV companies, those managing directors allowing payment of dividends or other distributions to shareholders while at the time knowing (or reasonably able to foresee) that after the payment the company would not be able to pay its due debts, will be jointly and severally liable towards the company for the deficit created by the payment.
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?	If an officer, shareholder or other person who has not been appointed as a managing director, commits factual acts of management, they are liable on the same footing as a managing director for such acts (and, in principle, for such acts only) as a 'de facto director'. They are deemed a 'de facto director' only, however, if they commit such acts in place of the formally appointed managing directors or have instructed such appointed managing directors to act in a certain manner. The burden of proof is on the creditor (or the bankruptcy trustees, as the case may be).

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')?	Managing directors will be liable if they enter into new obligations on behalf of the company when, at that time, they know or should have realised that the company will not be able to fulfil those obligations and that the company will be unable to pay the resulting claim for damages (no 'light at the end of the tunnel'). The burden of proof rests, in principle, on the prejudiced creditor. Even if there is 'light at the end of the tunnel', managing directors should be careful not to actively paint or endorse a misleadingly rosy picture of the company's financial situation.
5.	What are the liability risks in the case of 'creditor stretching'?	The mere fact that a managing 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 outside creditors are stretched but debts to related parties are paid on time, this may create directors' 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 case there are insufficient funds available to pay all creditors, companies are entitled to pay those creditors which are key for the company's short term survival (employees, certain suppliers) and delay payment to others, as long as there is a credible prospect of a refinancing/survival. If there is no such 'light at the end of the tunnel' any more, the company and its directors should aim for equal treatment of creditors. In practice this means quickly seeking bankruptcy or 'suspension of payments' protection under the Dutch Bankruptcy Code. In the short interval prior to such bankruptcy declaration/suspension of payments, selective payments should then only be made if there are compelling grounds to do so, such as preserving value in the company's assets for the benefit of all creditors.
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 will not easily be convinced that there was a compelling reason (in the interest of the company and its creditors) to give preferential treatment to related entities.

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 articles of association to that effect. On the other hand, the management board requires shareholder approval to file for bankruptcy, unless this has been excluded in the articles of association.
9.	Is there an obligation at some stage to file for bankruptcy or other statutory insolvency protection regimes?	There is no formal rule in Dutch law obliging a financially distressed company to apply for its own bankruptcy or suspension of payments at a given point in time. It would nevertheless be prudent to file for such court protection if there is no 'light at the end of the tunnel'. Filing under these circumstances would help to ensure that all creditors receive equal treatment.
10.	Are there special liability risks in respect of certain debts, such as tax debts, social security payments, and pension contributions?	Yes. Companies must make immediate written notification to the competent authorities in the event they are unable to pay specific taxes, social insurance premiums and/or compulsory contributions to company pension funds. If not, managing directors are jointly and severally liable for the taxes or premiums due and can exonerate themselves only by showing that (a) they are not to blame for the company having failed to (properly) fulfil its notification obligation as they themselves were physically or mentally unable to give the notice and (b) that they are not to blame for the non-payment of the various amounts. If the notification obligation has been fulfilled, a managing director is only liable if the relevant authorities can show that the non-payment is due to apparent improper management by the managing directors jointly in the period of three years preceding the time of the notification.
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?	In principle, as mentioned at 2., a management board member is liable only if their acts or omissions are seriously and personally reproachable. Note, however, that the members of the management board are collectively responsible for the company's policies and affairs. On the other hand, board members can exonerate themselves by proving that they cannot be blamed for the mismanagement and has not been negligent in taking measures to avert its consequences. In that context, they may point to a division of tasks within the board. The burden of proof lies with the managing director.

No.	Question	Answer
12.	Are there specific actions against directors under bankruptcy law?	Yes, in a bankruptcy each managing director is jointly and severally liable for the deficit in the bankruptcy estate in case of apparent mismanagement in the three years preceding the bankruptcy, if it is apparent that the insolvency has, to a large extent, been caused by that mismanagement. Individual managing directors can exonerate themselves by proving that they cannot be blamed for the mismanagement and have not been negligent in taking measures to avert its consequences. The court can furthermore mitigate liability on various grounds. There is a non-rebuttable presumption of mismanagement (and a rebuttable presumption of its causing the bankruptcy) if the company has failed to keep proper records of its rights and obligations or failed to publish its annual report and accounts within 12 months of the end of the financial year.
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 as such do not trigger specific duties of, or consequences for, shareholders or group companies. Shareholder receivables will not automatically be subordinated. Shareholders or group companies may however be liable towards the company in case of wrongful interference in the company's affairs, as de facto directors or otherwise. Shareholders of a B.V. company (*besloten vennootschap*) will be liable to repay dividends paid out by the company if they knew at the time (or should reasonably have foreseen) that the company would not be able to pay its due debts.
14.	Is there special legislation mitigating the liability risks of directors specifically in view of the Covid-19 crisis?	No.

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