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.

United Arab Emirates

This memorandum provides an overview of the duties and liabilities of members of the board of managers or directors (as applicable) of 'on-shore' limited liability companies (**LLCs**) and joint stock companies (**JSCs**) in the UAE, with a focus on those that may arise when an LLC or a JSC is in financial difficulties. A reference to a **company** or **companies** means an LLC and/or a JSC, as applicable. The memorandum does not provide a detailed overview of directors' duties and liabilities that may arise from sector specific legislation passed in the UAE, nor does it account for the additional duties and liabilities that may exist for directors of companies incorporated in one of the many UAE free zones.

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?	The duties and liabilities of UAE directors are derived from various sources. The main source is the Federal Commercial Companies Law No.2 of 2016 (the **CCL**), but provisions are also found in, amongst others, Ministerial Decision No.272 of 2016, the Federal Law on Civil Transactions 1985 (the **Civil Code**), and Federal Penal Code 1988 (the **Penal Code**). For companies in financial difficulties, Federal Decree-Law No.9 of 2016 concerning bankruptcy (the **Bankruptcy Law**) will also be important, and this is discussed in more detail below. The Securities and Commodities Authority has set additional corporate governance rules for the directors of public JSCs (Resolution No.3 R/M of 2020), and relevant legislation for private JSCs includes Ministerial Resolution No.539 of 2017, as amended. UAE directors' obligations are broadly in line with other jurisdictions, and include: (i) preserving the interests of the company and exercising the care of a diligent person in performing their duties; (ii) acting in accordance with the company's objectives; (iii) ensuring they do not act fraudulently, commit gross errors, improperly use the power granted to them, or otherwise contravene applicable law, the memorandum of association or any contract of appointment; (iv) declaring conflicts of interest, refraining from voting on conflicted matters and refraining from undertaking the management of a competing company without the prior consent of the shareholders; and (v) preserving the confidentiality of company information.

No.	Question	Answer
		Generally, directors are liable to the company itself, its shareholders (also known as partners) and to any other person to the extent that such liability arises from an act of fraud. This is codified in two articles of the CCL: (a) Article 84(1) provides that: *'every director in an LLC shall be liable against the company, the partners and the third parties for any fraudulent acts by such director and shall also be liable for any losses or expenses incurred due to improper use of the power or the contravention of the provisions of any applicable Law, the memorandum of association of the company or the contract appointing the director or for any gross error by the director. Any provision in the memorandum of association or the contract appointing the director in conflict with the provisions of this clause shall be deemed void'*; and (b) Article 162(1) provides that: *'directors of a JSC will be liable towards the company, its shareholders and third parties for all actions of fraud, abuse of authority, violations of the law or the company's articles of association and for any errors in management, and any provision to the contrary shall be void'*.[1] However, in our view, the overarching duty of directors of a company in financial difficulties would shift towards protecting the interests of all stakeholders, which includes creditors. The scope of these duties is not entirely clear under UAE law, and international best practice can provide a guide to a certain extent. However, it is likely that if the company's financial distress could be considered as insolvency under the Cash Flow Test or Balance Sheet Test (as defined in the response to question 9 below), then the directors may potentially be found to owe a primary duty to the interests of the company's creditors, even to the exclusion of the interests of its shareholders. The Bankruptcy Law imposes an obligation to file for a restructuring scheme or insolvent liquidation of a company when certain conditions are satisfied (as described in more detail in the answer to question 9 below). Directors must also remain continuously diligent in their assessment of the financial condition of the company (as discussed in more detail below). As a general comment, directors must ensure the company practises good corporate governance, especially at times when a company may be in financial difficulties, and a detailed record of decisions taken by the directors, including details as to the reasons why such decisions are taken, should be maintained. Regular meetings should be held to review decisions taken.
2.	What are the key areas of potential liability for directors when a company is in financial difficulties?	The key areas of potential liability for directors when a company is in financial difficulties include: (a) committing fraudulent acts and acting ultra vires (pursuant to Articles 84 and 162 of the CCL, as discussed in more detail in the response to question 1); (b) distributing fictitious profits to the shareholders of a company; (c) conducting related party transactions or 'preferred transactions' at an undervalue; (d) failing to call a general assembly meeting in situations where a company's losses have reached half of its capital, or issued share capital in the case of a JSC; (e) failing to refer the issues around the Cash Flow Test or Balance Sheet Test to the shareholders for the latter to resolve on the insolvency within the time limits set out under the Bankruptcy Law; and (f) if a court declares a company bankrupt and it is found that the company's assets are insufficient to settle at least 20 per cent of its debts, the Bankruptcy Law provides that the directors may be ordered to pay all of the company's debts where the directors are found to have breached their duties under the CCL.

1_Pursuant to Articles 24 and 167 of the CCL, it is not possible to exempt directors from liability. Therefore a special shareholders' resolution discharging a director from liability vis-à-vis the shareholders may not be enforced. In any event, such resolution would not discharge that director's liability towards other directors or third parties (including creditors of the company).

No.	Question	Answer
		Directors who fail to comply with the duties set out in the CCL (as summarised in the response to question 1) may be sued for their errors by the company or its shareholders, assuming any claimant can prove damages. A director who has breached the CCL may be subject to financial penalties and/or criminal sanctions. Penalties and sanctions set out in the CCL include: (i) fines of between AED20,000 and AED1,000,000; or (ii) imprisonment for between six months and three years. Chapter 2 of the CCL provides the detailed list of penalties and sanctions that a director may face if they have breached their duties under the CCL. It is also possible that directors could also potentially face liability under certain provisions of the UAE Civil Code. The Bankruptcy Law also prescribes additional criminal and civil sanctions that may be charged against a company's directors for breach of duty under the Bankruptcy Law. The response to question 12 lists the applicable civil and criminal sanctions in more detail. However, the Bankruptcy Law also provides for the concept of director disqualifications. Any director found to have breached the Bankruptcy Law may be disqualified from managing any other company (or any other form of company in the UAE) for up to five years. Further, directors will need to consider carefully the timing of any resignation. Under Article 667 of the Civil Code, a director is under a duty to resign their directorship only at a time which would not cause damage to the company. Arguably, if a director has experience in weathering economic cycles and/or is crucial to the operations of the business, the resignation of the director may potentially be found to have caused damage to the company. The Penal Code also provides that directors may face imprisonment for up to five years in the event that they accept a promise or a grant in return for performing or abstaining from undertaking acts that are required in their role as a director of a company (Article 236/1).
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?	Article 22 of the CCL applies not only to directors but also to other persons authorised to manage a company. As a result, the obligations imposed under Article 22 of the CCL can potentially extend to non-directors (including, for example, a chief executive or similar officer who is not also a member of the board of managers). Liability rests not only with directors but also on other persons who are authorised to manage a company, and in the case of criminal sanction, any person under whose instructions or directives the managers act.
4.	What are the standards for directors' liability for the company having entered into contracts that the company can later not perform ('wrongful trading')?	Continuing to incur further credit or borrow further money when the company may be unable to repay the debt or pay for goods or services can lead to civil or criminal sanctions for the directors under the Bankruptcy Law, as discussed in more detail in the response to question 12 below. As discussed in the response to question 1, there is also a general duty upon directors to ensure that a company is not mismanaged and to ensure that the director performs their duties to the standard of a diligent person. Directors concerned about the financial position of the company should therefore ensure they assess it by reference to the insolvency tests set out in the Bankruptcy Law, discussed above, as soon as concerns arise. It will at this point be crucial that directors are conscious of their overall duty to act in the best interest of all stakeholders. It may be challenging for a director to argue that such duty has been discharged when further credit and borrowing is taken on by a company that is, or foreseeably may shortly be, in financial difficulties. Notwithstanding the above, the Bankruptcy Law does provide that new financing may be extended to a company that is subject to preventative composition or debt restructuring proceedings provided that the court approves the new financing arrangement.

No.	Question	Answer
5.	What are the liability risks in the case of 'creditor stretching'?	The position on 'creditor stretching' is not entirely clear. As long as the directors are acting reasonably with the intention of maximising the possibility of a full recovery for creditors as a whole (or minimising losses to creditors where a recovery is not possible), we believe there should be some limited flexibility. As noted, the directors should ensure management decisions are reviewed regularly and comprehensively documented, in case of any subsequent challenge. However, directors should be aware of the company's obligation to file for a restructuring scheme or insolvent liquidation when certain conditions are satisfied (as described in more detail at question 9 below) and the obligation to notify the shareholders of such. There is some uncertainty as to when such application must be made, however, and as the position under the Bankruptcy Law is untested, directors should be aware of the potential risks in these circumstances.
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?	Once the restructuring or insolvent liquidation (ie, bankruptcy) process is approved/declared, the management of the company is normally precluded from making dispositions of the company's assets and the management of the company would be handed to a trustee. That said, selective payments to creditors made in the two-year period prior to a trustee taking management of the company are at risk of being deemed unenforceable and may be unwound (Article 147 of the Bankruptcy Law) if the payment is found to be detrimental to the other creditors (Article 201(4) of the Bankruptcy Law). Further, creditors that enter into *'secret agreements that give the creditor special benefits to the detriment of other creditors'* (Article 207(3) of the Bankruptcy Law), may face criminal sanctions and be punished by imprisonment. Given the above, directors of a company in the twilight zone should ensure they treat all creditors (within the same rank) equally based on the Bankruptcy Law's provisions and their general duty of care legislated for under Article 22 of the CCL and Article 6 of the Ministerial Resolution. Additionally, directors should note that, if a payment by the company to a creditor is found to be of a selective nature that is detrimental to other creditors, in addition to the court ordering for the payment to be clawed back, the directors may face civil and criminal sanctions under the Bankruptcy Law (as set out in the response to question 12 below).
7.	Is there a distinction in this regard between preferential treatment of related entities and the treatment of other creditors?	The Bankruptcy Law designates the two-year period preceding the decision to accept the bankruptcy application as a 'suspicion period' for clawback purposes and reviews all transactions conducted by the debtor during this period. Transactions occurring during this period, which are determined by the court to have been carried out with no consideration or to have been undervalued or to be detrimental to the creditors (where the counterparty knew or should have known of the debtor's insolvency or being in cessation of payment) will not be enforceable against other creditors and may be unwound, unless court authorisation for the transactions is obtained. Given the above, during uncertain economic times, related party transactions and potential 'preferred transactions', including those with shareholders or creditors, will need to be examined closely by directors to ensure they are executed on an arm's length basis in order to avoid the potential risk of clawbacks by the UAE courts.

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?	If a company's losses reach half of its capital, or half of its issued share capital in the case of a JSC, the directors must refer the issue of dissolution to a shareholders' meeting and a resolution to dissolve the company can be passed by the same majority required to change the memorandum of association. If the losses in an LLC reach 75 per cent of its capital, shareholders holding only 25 per cent of the capital may request dissolution. Failing to call such shareholders' meeting may result in the chairman (and where there is no designated chairman, the directors) of the company being liable to pay a fine of between AED50,000 and AED1,000,000 (Article 344 of the CCL). The initiation of either of the processes set out in the answer to question 9 requires a resolution to that effect from the extraordinary general assembly of the shareholders.
9.	Is there an obligation at some stage to file for bankruptcy or other statutory insolvency protection regimes?	A company will be insolvent under the Bankruptcy Law if it ceases to make payments of due debts at maturity for more than 30 consecutive business days as a result of its unstable financial standing (the **Cash Flow Test**), or has assets that are insufficient at any point in time to cover its 'payable obligations' (current liabilities) (the **Balance Sheet Test**). According to the Bankruptcy Law, a company (following a decision to that effect from its extraordinary general assembly) facing financial difficulties: (a) can voluntarily file, pursuant to Article 6(1) of the Bankruptcy Law, for the commencement of the formal process of preventative composition when the company is solvent and has not failed either the Cash Flow Test or Balance Sheet Test; and (b) must mandatorily file, pursuant to Article 68(1) of the Bankruptcy Law, for the formal process of a restructuring scheme or liquidation where the company has failed the Cash Flow Test or Balance Sheet Test. It is not entirely clear from the Bankruptcy Law when an application must be made. A conservative approach would be to assume that this should be done as soon as practicable following the occurrence of the relevant event described in limb (b) above. That said, we consider that directors of a company should as soon as possible make the shareholders aware of this but the company is not obliged to file immediately upon the failing of the Cash Flow Test or Balance Sheet Test. Instead, the company should have some latitude on when to file, noting the duties of directors discussed above. It may be that continuing to trade could be in the best interests of the company's creditors (for example, if additional revenues are expected further down the line). The critical point is to ensure that any decisions of the directors and shareholders to that effect are taken for the right reasons, with the interests of the company's creditors in mind. Directors should also ensure there is an audit trail for such decisions being made so that they can be referred to in the case of any question over board decisions (the importance of good corporate governance is referenced in other responses in this note). However, the Bankruptcy Law is not a model of clarity on this point and it is possible to argue the contrary to the above. What is clear, however, is that any flexibility around the timing of filing is limited. For instance, it would be difficult to argue that a company may not file when there were limited prospects of improving its financial position for the benefit of its creditors.

No.	Question	Answer
10.	Are there special liability risks in respect of certain debts, such as tax debts, social security payments, and pension contributions?	The Bankruptcy Law does not provide special liability for specific categories of 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?	In the UAE, a single person (a director) may manage an LLC. Alternatively, a board of managers (which is akin to a board of directors) may manage an LLC. A JSC, however, must be managed by a board of directors. All directors are liable if the fault occurs as a result of any resolution adopted unanimously, but if the resolution was adopted by a majority, the dissenting minority are not liable if their objections were entered in the minutes of the relevant meeting. Even if a director is absent from the meeting at which the resolution was adopted, that director will not necessarily escape liability unless they can prove that they were not aware of the resolution, or that they were aware of it but were unable to object to it. An action for damages in respect of loss suffered by the shareholders arising from errors of the directors may be initiated following a shareholders' resolution or by a liquidator. Even if the directors' actions have been ratified by the general assembly meeting, an independent shareholder may still sue the directors within one year of the date of the meeting. Upon the expiry of the one-year period, any proceedings against the directors will become time barred if the actions leading to the proceedings were previously ratified by the shareholders. However, if the action amounts to a criminal offence, the directors may be sued at any time.
12.	Are there specific actions against directors under bankruptcy law?	Breaches of the Bankruptcy Law may result in civil and/or criminal liability for a director of a company. The below sets out a high-level summary of the sanctions that directors may face: (a) Civil sanctions Where a company is declared bankrupt, the bankruptcy court may impose civil sanctions on the company's directors if, within the two years preceding the date of initiation of a formal process of preventative composition, restructuring scheme or bankruptcy procedures (the **Bankruptcy Procedures**), the company has entered into certain types of transactions. Broadly speaking, this applies where the company has entered into transactions at less than market value or transactions which prefer individual creditors to the detriment of other creditors. The bankruptcy court may also impose civil sanctions on directors in circumstances where the assets of a bankrupt company are insufficient to cover 20 per cent of its debts.

No.	Question	Answer
		(b) Criminal sanctions Criminal sanctions may be imposed on directors of a company either: (a) after the initiation of Bankruptcy Procedures; and/or (b) after the company is declared bankrupt. For these purposes, the Bankruptcy Law defines a 'manager' as *"every person who works for a company and who plays an active role in the decision making process in the company, and this includes any person under whose instructions or directives the managers act."* These criminal sanctions require a higher level of culpability than any of the civil sanctions. Generally, in order for a director to be criminally liable, an element of fraud or deceit is required. As a result of this, these sanctions carry large fines (up to AED 1,000,000) and prison sentences (up to five years). The acts which are subject to the criminal sanctions include: (i) concealing, altering or destroying all or part of the company's records with the intention of harming creditors; (ii) embezzling or concealing part of the company's money; (iii) knowingly acknowledging debts which are not owed by the company, whether in writing, orally or other conduct set out under the Bankruptcy Law; (iv) fraudulently obtaining a scheme of preventative composition or a restructuring scheme of the company; or (v) misrepresenting the amount of the company's paid-up or subscribed share capital, or distributing fictitious profits beyond the amount permitted by the company's constitution or the amount permitted by law. The civil and criminal sanctions set out above will not apply to a director where it is proven that the director in question has not been involved or has not participated in the act giving rise to the civil or criminal offence, or who has objected to the decision leading to that activity. For the purposes of mitigating the risk of liability, it is critical that the board keep accurate minutes recording board discussions and to ensure that any reservations about a particular course of action are fully discussed and expressly reflected in the minutes.

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?	UAE law does not have a general law of shareholder duties nor are there thin capitalisation rules. There is no specific concept of equitable subordination. The corporate veil may be pierced in certain circumstances. Most relevant for these purposes is where a company is managed by one or more of its shareholders. Such shareholders could be held jointly or severally liable for the company's debts and liabilities if the company is declared bankrupt, if the shareholders are responsible for: (i) taking decisions that led to the company failing the Cash Flow Test or the Balance Sheet Test in accordance with the provisions of the Bankruptcy Law; and/or (ii) knowingly approving transactions at an undervalue (as discussed in the responses to questions 2 and 7 above).
14.	Is there special legislation mitigating the liability risks of directors specifically in view of the Covid-19 crisis?	There has been no special legislation limiting the liability risks of directors in response to the Covid-19 crisis. The UAE Federal Government has, however, taken measures to attempt to relieve financial difficulties for companies, and therefore indirectly mitigate the problems that directors may face when assessing the financial outlook of a company. Directors should also ensure they are aware of legislative developments and government schemes that a company may utilise to alleviate circumstances of financial difficulty. In the UAE, an example of such government scheme includes the federal Targeted Economic Support Scheme (the **TESS**). TESS was introduced in March 2020 with the objective of attempting to provide temporary relief for a period of up to six months on outstanding loans for private companies affected by Covid-19. The relief applies to principal amounts and outstanding interest on loans obtained through banks in the UAE, the administration of which is managed by participating banks in the UAE.

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