Directors' duties under COVID-19 legislation: A comparative perspective

Catarina Serra compares the roles of Directors in light of new legislation in response to the crisis

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> **The suspension or freezing of the duty to file for insolvency is a positive measure; it requires, however, some precautions**

The case for Insolvency Law

It goes without saying that the COVID-19 crisis had a huge impact on the economy and gave rise to a wave of emergency legislation aimed at supporting the survival of businesses.

On the brink of the transposition of the European Union Directive on restructuring and insolvency, one of the most fruitful areas of intervention is Insolvency Law. With the appropriate temporary adaptations, the usual instruments of Insolvency Law may play a vital role in addressing the current widespread situation of businesses. Sometimes, however, the only thing which is necessary is to temporarily suspend or put on hold their enforcement. This is precisely what happened with the catalogue of directors' duties laid down on Article 19 of the Directive, for the event of likelihood of insolvency.

In jurisdictions which provide for the duty to file for insolvency, one of the most immediate measures (the only measure, in some cases) was the suspension of the duty. The justification is obvious: since the breach of duty leads to the liability of company directors, the measure brings them some sense of relief. In the remaining jurisdictions, steps were also taken towards a certain appeasement of directors' duties.

How are these measures useful to tackle the business crisis?

Suspending the duty to file for insolvency

Germany was one of the first countries to intervene in the domain. The duty to file for insolvency[1] is blocked until 30 September 2020 (with the possibility of extension until no later than 31 March 2021, if this appears necessary due to the continuing demand for available public aid, ongoing financing difficulties or other circumstances). The suspension is accomplished through a well-thought system of negative pre-requisites facilitated by presumptions. More precisely, the suspension shall not apply where insolvency is not a result of the COVID-19 pandemic or where there are no prospects of remedying the insolvency; where the debtor was not illiquid on 31 December 2019, it is assumed that the insolvency is a consequence of the COVID-19 pandemic and that there are prospects of remedying the insolvency.

Other legislators followed the path, although using different methods. In Spain, the duty to file for insolvency[2] is suspended until 31 December 2020. In Portugal, the suspension was established even in a plainer way, i.e., the duty to file for insolvency[3] is suspended with absolutely no requirements until further notice. The French legislator used a distinct formula: for the period of three months following the cessation of the emergency state the debtor's situation is to be assessed with reference to 12 March 2020 (when the emergency period commenced). By means of this "crystallisation", the duty to file for insolvency[4] is, in practice, "frozen" during the period of three months following the cessation of the emergency state.

The suspension or freezing of the duty to file for insolvency is a positive measure; it requires, however, some precautions.

When – but only when – the company's insolvency is a consequence of the COVID-19 crisis it is justified (fair) that directors are exempted from the duty to file (the COVID-19 crisis is an exogenous factor, a cause beyond their reasonable control). Besides, only then is insolvency likely to be temporary and there are good prospects of rescuing the company. Hence, an indispensable normative requirement is the evidence or the assumption that the company's insolvency is a COVID-19-crisis-related insolvency.

As the ultimate concern in this scenario is to solve the insolvency problem, the duration is another core aspect. Restructuring attempts involve sometimes imaginative and complex operations; directors ought to be given enough time to carry them out. Thus, the suspension should last for a (realistically) reasonable period, with the possibility of extension, depending on the circumstances.

Unfortunately, not all legislators have paid attention to the need to limit the scope of application and to establish a reasonable duration, in the above-described terms.

In any case, the suspension of the duty to file for insolvency falls short of the necessary measures. In order to give directors scope for action and encourage them to strive for the company's rescue, additional measures must accompany it.

Blocking the opening of insolvency proceedings upon request

It is useful, for one, to suspend, in similarly cautious terms, the opening of insolvency proceedings upon request of the debtor, the creditors and other individuals entitled to do it. The final aim is to restrain the probable "insolvency tsunami", within which a large number of companies would be doomed to a (most likely unjustified) asset liquidation.

Measures of this kind were adopted in some (but not all) of the countries where the duty to file for insolvency is suspended. In Germany, in the period from 28 March 2020 to 28 June 2020 (likely to be extended to 31 March 2021), no insolvency proceedings are to be open except if they are based on an insolvency situation which pre-existed (i.e., existed prior to 1 March 2020). And in Spain, until 31 December 2020, courts are not allowed to open insolvency proceedings upon request; should the debtor file for insolvency before 31 December 2020, his/her request will have priority even if submitted on a later date than the other persons' request.

Alleviating the duties and the liability of directors

As the duty to file for insolvency is not the sole duty of company directors (and, in certain jurisdictions, it does not even exist), it is appropriate to mitigate further the rules on directors' duties and liability.

Again, some (but not all) of the countries which suspended the duty to file for insolvency adopted measures of this kind. In Germany, the risk of directors' liability has been considerably reduced, with the law providing that payments which are made in the ordinary course of business, in particular those payments which serve to maintain or resume business operations or to implement a restructuring plan, are deemed to be consistent with the due care of a prudent director and that credit granted and collateral provided during the period of the suspension are not deemed to be contributing, *contra bonos mores*, to the delayed filing of a request for insolvency. In Spain, the legislator elected a different target: since company directors may be liable when there is a serious loss of the legal capital (when net assets fall below 50% of the legal capital) and they fail to adopt the measures prescribed by law (namely, to promote the dissolution of the company), it is laid down that the losses in the financial year of 2020 shall not be taken into consideration for the purpose of assessing directors' liability.

As previously noted, in some jurisdictions the duty to file for insolvency does not exist as such and instead, a general duty to abstain from insolvent trading is in place. In these jurisdictions, the legislative intervention focuses on liability for insolvent trading and aims at granting company directors what is called a "safe harbour". In Australia, for a period of six months, company directors shall be temporarily relieved of their duty to prevent insolvent trading with respect to any debts incurred in the ordinary course of the company's business, except in cases of dishonesty and fraud (which will be subject to criminal penalties). In New Zealand, directors' decisions to keep on trading, as well as decisions to take on new obligations shall not result, for a period of six months, in a breach of duties if the director, in good faith, is of the opinion that: (1) the company has, or in the next six months is likely to have, significant liquidity problems, which are, or will be, a result of the effects of COVID-19 on the company, its debtors, or its creditors; (2) as at 31 December 2019, the company was able to pay its debts as they became due in the normal course of business; and (3) it is more likely than not that the company will be able to pay its due debts on and after 30 September 2021.

Finally, in the United Kingdom, wrongful trading provisions are suspended since 1 March 2020 for the estimated period of three months (which may be extended). The general belief is that the existing laws for fraudulent trading and the threat of director disqualification will continue to act as an effective deterrent against director misconduct.

To be sure, measures of this kind have to be very well balanced so as to avoid the total elimination of directors' duties, in particular the duty "*to consider or act in the interests of creditors of the company*" [in the wording of Article 172(3) of the UK Companies Act 2006] or "*to have due regard to the interests of creditors, equity holders and other stakeholders*" [in the wording of Article 19, a), of the Directive], which is somehow present in every jurisdiction and acquires special relevance these days.

Final remarks

Clearly, the adoption of all the measures mentioned above, either alone or combined, is neither sufficient nor does it allow us to imagine that the problem of business insolvency is solved. Nevertheless, it is likely to contribute to the reduction of the avalanche of insolvency proceedings which will certainly hit commercial courts and drive to a fast track liquidation of otherwise viable businesses.

More importantly, it prevents that well-intentioned and responsible company directors become averse to taking on decisions and to engaging in operations which, although apparently risky, may be indispensable to accomplish the recovery.

It is true that the rules were not always put in place in the most appropriate ways and that, in certain jurisdictions, some of the rules may even be lacking. This might undermine the whole purpose of the solution (to give directors scope for action). But there is still time to address the shortcomings wherever necessary. ■

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Footnotes:

1 Under German law, directors shall file for insolvency, at the latest, three weeks after the commencement of insolvency (*Zahlungsunfähigkeit*) or overindebtedness (*Überschuldung*) (Section 15a *Insolvenzordnung*).

2 In Spain, the period to comply with the duty is two months since the directors were aware or ought to have been aware of the company's insolvency (Section 5.1 *Ley Concursal*).

3 In Portugal, directors have thirty days from the moment they were aware or ought to have been aware of the company's insolvency (Section 18, n.º 1, *Código da Insolvência e da Recuperação de Empresas*).

4 In France, directors must comply with the duty within forty-five days since the commencement of the insolvency (*cessation des paiements*) (Section L.631-4 *Code de Commerce*).