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Directors’ duties of financially distressed companies in the time of COVID-19

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Unlike other jurisdictions around the world, several European countries require corporate directors to file for bankruptcy once a company becomes insolvent. For instance, under German law, corporate directors are required to file for bankruptcy within three weeks since they know, or ought to have known, that the company became insolvent on a balance-sheet or a cash-flow basis. Failure to comply with this duty may expose the directors to both civil and criminal liability. In Spain, a similar duty is imposed. However, instead of exposing directors to criminal liability, they can be subject to other sanctions (including disqualification and liability for the company's debts) and the bankruptcy petition has to take place within two months rather than three weeks. Such a duty can be extended, however, for four additional months if the directors notify the court the commencement of negotiations with the company's creditors with the purpose of reaching an out-of-court agreement.

In addition, regardless of whether a company is insolvent, many European countries also impose certain duties on corporate directors when, as a result of the existence of losses, the company's net assets fall below a certain percentage of the company's legal capital. For example, under Spanish corporate law, directors are required to promote the dissolution, restructuring or bankruptcy of the company within two months since they know—or ought to have known—that the company's net assets have fallen below 50% of the company's legal capital. If they fail to do so, directors will be liable for the company's new debts.

Due to the impact of the coronavirus in Europe, many companies will be exposed to both losses (as a result of their fixed costs and decline in revenues) and insolvency (due to many companies' inability to generate the cash-flows needed to meet their financial obligations). For this reason, I recently wrote an article advocating for a legal reform in Spain that can nevertheless be applied to other countries. Among other policy recommendations, I suggested that the legislator should suspend both the duty to file for bankruptcy and the duty to promote the dissolution or restructuring of those companies whose net assets fall below 50% of the company's legal capital. In the absence of these measures, which should last long enough to let companies overcome the financial difficulties generated by the COVID-19, many otherwise viable companies would be forced into liquidation or bankruptcy proceedings. Therefore, the legal framework would exacerbate the harmful economic effects already created by the coronavirus.

During the past days, it seems that some European countries have decided to take actions on these matters. On 16 March 2020, the German Government announced a suspension on the duty to file for bankruptcy for companies affected by the coronavirus. One day later, the Spanish Government implemented a reform in the same direction (see articles 40.11, 40.12 and 43 of the Royal Decree 8/2020 of 17 March 2020).

However, the Spanish approach differs from both my policy recommendations and the German approach in various relevant aspects. First, instead of imposing a suspension lasting long enough to let Spanish companies recover from the losses and financial difficulties generated by the coronavirus, as it was suggested in my article and has been announced by Germany (that is planning to suspend the duty to file for bankruptcy until 30 September 2020, with the possibility of an additional extension to 31 March 2021), the Spanish suspension will just apply while the country remains in a state of emergency (estado de alarma), which has been declared until 29 March 2020, even though it can extended by Parliament.

Second, with the purpose of avoiding the opportunistic use of this suspension, my proposal just targeted companies or economic sectors affected by the coronavirus, which seems to be the solution likely to be adopted in Germany. In Spain, however, the suspension targets all companies.

Third, while Germany has merely suspended the duty to file for bankruptcy (due to the absence of a 'recapitalize or liquidate' rule, as it exists in Spain as well as in Italy, France and Sweden), Spain has suspended both the duty to file for bankruptcy (applicable to insolvent firms) and the duty to promote the dissolution, bankruptcy or restructuring of the company (applicable to companies whose net assets fall below 50% of the company's legal capital). In my opinion, this latter legal response was necessary in Spain—¬as well as in other countries with a recapitalize or liquidate rule in place. Otherwise, solvent and viable companies just reporting losses might be forced to exit the market. Yet, the Spanish response can be criticized for having erred in the design of the suspension: on the one hand, its scope is too broad. On the other, its temporal extension is too limited.

Fourth, unlike the solution that has been announced in Germany, Spain has also suspended creditors' right to file an involuntary bankruptcy petition. In this regard, the Spanish response seems very reasonable. Otherwise, even if the suspension of the duty to file for bankruptcy shields corporate directors from liability for a failure to file for bankruptcy in a timely manner, the company can still be put into bankruptcy. And if so, apart from having to bear the direct and indirect costs associated with a procedure that, in the absence of these exceptional circumstances, would not even be needed, the directors may be removed from the company's management and, particularly in Spain, they can still be subject to several sanctions, including disqualification and special liability rules.

While these reforms will not help improve the financial situation of the companies affected by the coronavirus, and therefore need to be accompanied by other economic, financial, labor, legal and tax measures (some of which have already been implemented), they still represent a significant improvement. On the one hand, they provide companies and directors with a breathing space. On the other hand, these reforms help avoid the destruction of value associated with liquidating economically viable firms just facing financial trouble due to a totally exogenous factor such as the coronavirus. Therefore, these corporate and insolvency law responses deserve to be applauded. In fact, they may even serve as a model for other countries heavily affected by the coronavirus, even if, under those jurisdictions, the duties of corporate directors in situations of insolvency and/or qualified losses are not as rigid as those existing in Germany and Spain. Besides, by having learnt from the flaws and limitations associated with the Spanish and, to a lesser extent, the German solutions, other countries could implement a more comprehensive response to effectively address the challenges of applying normal-times corporate and insolvency laws in the midst of a once-in-a-century global pandemic.

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