ADVANT

Company Directors Facing Financial Distress: A Cross-Border Perspective

CONTENT

THE POSITION OF DIRECTORS FACING FINANCIAL DISTRESS IN A CROSS-BORDER PERSPECTIVE

*EU Directive No. 2019/1023 on preventive restructuring frameworks (**"Directive"**) focuses on alternatives to insolvency liquidation when European companies are facing financial distress as well as on providing early warning to prevent insolvency proceedings and instead preserve businesses as going concerns.*

*We take a look at the Directive from a cross-border perspective, with a view to coordinating actions by the directors of a group of companies which we would assume to operate in the three **ADVANT** jurisdictions: France, Germany and Italy.*

I. WHAT MIGHT PROMPT DIRECTORS TO ACT?

The situation prompting directors to take a course of action different from 'business as usual' is often either (i) a lack of the financial resources necessary to continue payments to creditors on a regular basis or (ii) a loss in the net equity value of the company.

It is also important to note that the duties of directors may be different if the company faces full insolvency rather than a mere risk of insolvency.

A. Liquidity test and going concern outlook

As far as the definition of insolvency is concerned, we see that this is fairly similar across the three **ADVANT** jurisdictions, as it involves a pure cash-flow test. In Italy and France, insolvency is defined as the debtor's inability to pay its debts as they fall due with its immediately available assets, while in Germany a company is insolvent when it cannot pay at least 90% of its liabilities due within a period of three weeks.

If we turn instead to pre-insolvency situations, these are not clearly defined or considered as such by insolvency rules in all three jurisdictions. Italy and Germany have statutory definitions referring to a going concern outlook for the next 12 months: (a) a state of distress as a likelihood of insolvency shown by "inadequate" cash flows to meet obligations in the next 12 months in Italy, or (b) a situation where the company is over-indebted and does not have a positive going concern forecast for 12 months in Germany. For its part, France allows easy access to out-of-Court pre-insolvency proceedings for companies facing all types of difficulties: proven or foreseeable, legal, economic, or financial.

B. Equity test

If we consider the equity situation, we see also similarities in the value of losses, reducing the statutory capital to less than 50% (in France and Germany) or less than two thirds (in Italy), requiring the directors to promptly call a shareholders' meeting and (in Germany) continuously monitor developments which may jeopardize the continued existence of the company. When instead the entire statutory capital is lost, the company is dissolved, and a liquidator must be appointed (in Italy) or it must be determined whether the company still has a positive going concern prognosis (in Germany). In France, if the equity situation is not restored within 2 years, any third-party may act in Court to dissolve the company.

It should also be considered that the loss of the going concern outlook normally determines also a loss of the statutory capital of the company, as it causes a depreciation of the assets in the balance sheet and can thus precipitate the duties of the directors to file for an insolvency petition.

C. Third party initiatives

To provide a full picture of possible constraints for the directors to take action, it is also to be noted that statutory auditors have specific duties to prompt directors in such respect in most **ADVANT** jurisdictions. In Italy, they are entitled to file for insolvency if directors do not react appropriately; in France, they must alert directors and – if they do not react properly – they must alert the Court; in Germany, instead, there is no obligation to inform third parties of the existence of a possible reason for insolvency, or to file an application themselves.

Of course, across all **ADVANT** jurisdictions, the most compelling factor for directors to resort to a restructuring framework is to prevent and anticipate the initiative which could be taken by creditors to ask the Court to declare the company insolvent.

II. WHAT NEEDS TO BE DONE?

A. Risk of insolvency and early warning

This situation may be confusing for the directors to face, not least because there are not always clearly defined duties to perform, but rather certain flexible guidelines which need to be adapted to the specific situation at hand.

a. Early warning

Firstly, even in the absence of any warning sign as to a possible risk of insolvency, there are obligations to monitor the going concern outlook for a certain period in the near future. In Italy and Germany, there is an expressly stated duty to keep ongoing internal monitoring procedures in place: (a) in Germany, in the event of over-indebtedness, directors must always ensure that they still have a positive going concern forecast for the subsequent 12 months (this period has been temporarily reduced to four months until the end of 2023); (b) in Italy, the directors must set up and at all times keep in place (and statutory auditors have a specific duty to check that this is done) adequate administrative and accounting procedures to be able to timely foresee a risk of insolvency and take appropriate action. In France, directors have no specific obligations prior to the insolvency of the company, however, their conduct prior to insolvency will be considered in the context of sanctions (see III).

So, even in the absence of a specific provision by national insolvency laws, the duty of care of directors inherently includes a duty to monitor the financial situation of the company in order to ensure a positive cash flow outlook in the near future.

b. Actions to be taken

Once a risk of insolvency is identified by the directors, there are no strict and clearly defined obligations, but diligent behavior can mitigate liability risks. What can be said is that not acting could be considered mismanagement.

The Directive at Art. 19 provides that Member States shall ensure that directors 'have due regard, as a minimum, to the following: (a) the interests of creditors, equity holders and other stakeholders; (b) the need to take steps to avoid insolvency; and (c) the need to avoid deliberate or grossly negligent conduct that threatens the viability of the business.'

Certain general guidelines can help the directors to decide the most appropriate course of action. The directors should first assess whether there is a chance to preserve the going concern value. While assessing these scenarios, the directors should:

- act to preserve the going concern, such as by paying key suppliers, cutting unnecessary costs, resorting to redundancy schemes, pushing cash-efficient lines of business or activities, cease repaying overdue debt and unsecured bank loans;
- determine whether the chances to realize going concern value for the creditors are outweighed by losses which may keep accruing;
- resort to specialized professional advice in order to prepare a suitable restructuring plan and framework;
- actively look for a new investor, if necessary, either to support financially a restructuring plan, or to purchase the business as a going concern;
- avoid placing a creditor in a preferential position (although there is a varying degree of flexibility in different jurisdictions: in Italy and France, paying current suppliers while ceasing to repay bank debt would not be considered preferential; in Germany, this could lead to the insolvency administrator later contesting payments to the suppliers).

Once the directors have assessed that a reasonable chance of preserving going concern value exists, they should then consider:

- whether the restructuring plan can be implemented through out-of-Court negotiations with creditors, or a judicial restructuring framework is necessary;
- what is the most appropriate preventive restructuring framework (as defined in the Directive), whether protection against individual creditors' enforcement actions should be sought in order to avoid disruption to the restructuring process.

c. Available restructuring frameworks

National insolvency laws in the **ADVANT** jurisdictions provide for an array of different restructuring frameworks, either out-of-Court or semi-judicial schemes (see BOX 2), or fully judicial restructuring procedures (see BOX 3). These restructuring frameworks show marked differences, but all comply with the minimum requirements set by the Directive, i.e. that:

i. debtors remain at least partially in control of their assets and the day-to-day operation of their business (so-called "debtor in possession") (Art. 5);

ii. debtors can benefit of a stay of individual enforcement actions, providing also that creditors are not allowed to withhold performance or terminate existing contracts for an overall period not exceeding 12 months (Art. 6-7);

iii. restructuring plans can be submitted by debtors for adoption by the affected parties and confirmation by a judicial or administrative authority, under certain conditions, and are binding on all affected parties (Art. 8-16);

iv. new financing and interim financing are adequately protected (Art. 17);

v. transactions that are reasonable and immediately necessary for the negotiation of a restructuring plan are not declared voidable or unenforceable in the event of a subsequent insolvency (Art. 18).

The choice of the appropriate framework depends on the specific case of each company: need for confidentiality or not, whether there is a preference for an amicable framework, need to constrain creditors, plan to transfer all or part of the business etc.

In order to ensure that the directors are not unduly conditioned by the shareholders in discharging their duties in the interest of creditors, some **ADVANT** jurisdictions provide safeguards (see BOX 4).

In some circumstances, therefore, the directors of a company operating in all three **ADVANT** jurisdictions should be able to retain control of the business operations while resorting to a suitable preventive restructuring framework and implement an appropriate restructuring plan, with or without the support of a new investor, as the case may be.

The fact that restructuring procedures proceed separately and are governed by different national laws should not hinder a positive outcome, since (a) they are now harmonized after the recent implementation of the Directive, and (b) EU Regulation No. 2015/848 provides for the appropriate means of coordination of the various procedures and cooperation between the relevant bodies. It is not uncommon for Member State Courts to consolidate all the procedures in a single jurisdiction when it can be established that all companies of a group have a single center of main interests (COMI).

B. Insolvency

If the company is insolvent, the directors should act without delay in order to determine whether a restructuring under one of the frameworks referred to under A. above is indeed feasible even if the company is insolvent (e.g. by writing off a large part of the debt and rescheduling maturity), which is possible in all **ADVANT** jurisdictions.

If there is no reasonable chance to restructure the company in a pre-insolvency framework, the directors must file for insolvency without delay: some **ADVANT** jurisdictions provide fixed deadlines for the filing (45 days in France, and in Germany three weeks in the case of illiquidity and six weeks in the case of over-indebtedness - this period has temporarily extended to eight weeks until the end of 2023); in Italy, no specific deadline is provided, allowing more flexibility in considering if an alternative solution is feasible, in the interests of the creditors and all stakeholders.

A. *Liability of the directors for damages*

Any breach of the duties of care of the directors can lead to an assessment of their liability for damages vis-à-vis the company and its creditors. In general, in a pre-insolvency or insolvency situation, the directors will be held personally liable for the debts of the company if they have committed an act of mismanagement that contributed to determine or aggravate the insolvency, resulting in an excess of liabilities over assets (In Italy and Germany). In France, the relevant Court may hold directors liable for the payment of all or part of the unsettled debts of a judicial liquidation caused by their mismanagement.

a) Standards in insolvency and pre-insolvency

In case of insolvency, the timing of filing by the directors plays a relevant role, where a strict term is provided by law: (i) in France, although not a criminal offence, late filing may result in liability to pay all or part of the unsettled debts; (ii) in Germany, it constitutes a criminal offense and involves personal liability of the directors for damages incurred; (iii) in Italy, although there is no fixed term, directors are normally held liable for not having acted in a timely manner, as it is customary for insolvency receivers to argue that the company lost its share capital further back in time, due to depreciation of assets or recording of liabilities or risks which the directors omitted to include in the formal balance sheet.

In case of pre-insolvency, the duties of the directors to act promptly to put in place remedial actions to address the situation are relevant in assessing their possible liabilities in the context of their duties of care in order not to prejudice the interests of the creditors. The scope of the actions to be taken in this case, as noted above, is more varied. Directors can be held liable not only if they unduly delay resorting to a restructuring framework, but also if they do not avail themselves of expert advice or do not devise appropriate restructuring plans, and merely make attempts to defer actions by the most aggressive creditors. Moreover, directors can be held liable if they unduly seek the protections available under any of the restructuring frameworks provided by the law, resulting in further delay of an inevitable insolvency liquidation, when a diligent approach and assessment of the situation should have led them to an insolvency.

b) How are damages determined?

ADVANT jurisdictions differ significantly in this respect:

- Italian law specifies the criteria to determine damages in the insolvency context, which are presumed (the burden of proof to the contrary is placed on the directors) to be equal to the difference in net worth of the company from the moment the directors should have acted to the opening of the relevant restructuring or insolvency procedure;
- in Germany, the managing directors are personally liable for all damages incurred by creditors as a result of payments made by the company from the time it becomes insolvent (except for such payments as are absolutely necessary to maintain the business operations);
- in France, directors may be held liable for all or part of the unsettled debts; Courts have a discretionary power to set the relevant amount, but must respect a principle of proportionality between the fault and the damages.

c) Who can bring an action for damages?

In Germany and Italy, the action can be brought by the insolvency administrator as part of the insolvency proceedings opened.

In France, the action can be brought by the liquidator and the public prosecutor, or, in the event of the liquidator's failure to act, by the majority of creditors appointed as controllers.

In Italy, an action for damages is mandatory also in the context of a *concordato preventivo* (see BOX 3) based on a pure liquidation plan (in which case it is brought by the liquidator appointed by the Court): therefore, the directors have a specific incentive to push a plan which also indirectly preserves the business as a going concern (through a sale to third parties).

B) *Personal disqualification and other prohibitions*

The French Commercial Code provides for a limited list of behaviors that may lead to personal disqualification or other professional sanctions in the framework of insolvency proceedings.

Under German and Italian law, a director may be denied the right to manage a company if he has violated criminal provisions, in particular those relating to the protection of assets.

C) *Criminal offenses*

French, Italian and German law also provide criminal offenses in the scope of insolvency proceedings and severe punishments for the following behavior:

- fraudulently embezzling or concealing all or part of the company's assets or fraudulently increasing the company's debts;
- concealing accounting documents or failing to keep the accounts;
- obtaining credit at rates that are significantly higher than commercial rates or selling assets below market value (in Italy this could be even at market value), with the intent to avoid or delay the opening of insolvency proceedings.

In Germany and Italy, insolvency offenses also include:

- not filing an application for insolvency in good time or not filing it at all;
- intentionally providing a creditor with financial advantage (including preferential payments);
- helping an insolvent company to set aside assets or commit other punishable offenses.

BOX 1 – LEGISLATION

Italian Insolvency Code (hereinafter "Code") came into force on 15 July 2022.

German Insolvency Code (hereinafter "InsO") came into force on 5 October 1994, last amended on 20 July 2022.

"LIVRE VI" of the French Commercial Code is regularly updated. The latest reform in October 2021 had a significant impact on French insolvency law.

BOX 2 – OUT-OF-COURT OR SEMI-JUDICIAL RESTRUCTURING FRAMEWORKS

ITALY

Negotiated composition – This is not a restructuring procedure, but rather is meant to help the debtor, with the assistance of an expert appointed by the Chamber of Commerce, to negotiate an agreement with creditors within one of the restructuring frameworks provided for by the Code. The negotiated composition can work as an entirely out-of-Court and highly confidential negotiating environment, unless the debtor requests a stay to the Court or other interim measures.

Certified restructuring plans – The company may restructure its indebtedness based on a plan reinstating a balanced financial situation, so that the company can remain in business. The plan may provide an agreement with some creditors or third parties (e.g. for the sale of assets) or internal measures to regain efficiency. The feasibility of the plan must be validated by an expert appointed by the company. No Court approval or scrutiny is required. There is no stay of creditors' enforcement actions.

Debt restructuring agreements – The company may reach an agreement with creditors, by which its indebtedness is restructured in various possible ways, e.g. by delaying maturity, writing off debt, converting debt into equity. The agreement must be confirmed by the Court, who shall verify that the plan does ensure full payment of the other creditors. The effects of the agreement can be extended to creditors who did not accept it under certain conditions. The proceeding is very straightforward and can be completed in a few months.

GERMANY

StaRUG – With the Act on the Further Development of Restructuring and Insolvency Law (SanInsFoG), which came into force on January 1, 2021, the German legislator has implemented the requirements of EU Directive No. 2019/1023. The core of this law is the "StaRUG", which provides the required non-insolvency restructuring framework in its main section.

The initiative for restructuring according to StaRUG can come from the debtor alone. The formal prerequisite for using the StaRUG is that the debtor must notify the restructuring plan to the competent restructuring court. The material prerequisite for recourse to the StaRUG is the debtor's imminent inability to pay in accordance with the Insolvency Code. In principle, restructuring under the StaRUG can take place without public announcement.

The restructuring plan is based on the insolvency plan. In contrast to the insolvency plan procedure, however, the restructuring plan is a partial collective procedural arrangement, i.e. the debtor is granted discretion in determining which creditors shall be included in the plan.

However, claims arising from an employment relationship cannot be structured in principle. The creditors participating in the restructuring plan are grouped according to the nature of their claims. When voting on the plan, 75% of the respective group members must agree.

FRANCE

"Mandat ad hoc" and conciliation – Both proceedings are strictly confidential and aim at reaching an amicable agreement with all or part of the creditors. This voluntary agreement may include a rescheduling or waiver of debts. The agreement must end the company's difficulties and allows the continuation of its activities. In both "mandat ad hoc" and conciliation a third party (an insolvency practitioner called "mandataire ad hoc" or "conciliateur") is appointed by the presiding judge of the relevant Court to assist directors to find restructuring solutions (help to negotiate amicable agreement with all or part of creditors or search for new investors).

The scope of the mission of the "conciliateur" may include the search for a purchaser of all or part of the debtor activity (only in conciliation).

In the framework of a conciliation, directors may ask to the presiding judge of the relevant Court a grace period of up to two years if a creditor sends a formal notice or brings an action against the company.

Moreover, if a claim is due and payable and that a standstill is requested by the "conciliateur" and not granted by the creditor, directors may file a motion seeking a postponement of payments of up to two years.

BOX 3 – JUDICIAL RESTRUCTURING FRAMEWORKS

ITALY

Concordato preventivo – The company may propose an arrangement to the creditors based on a plan which may provide that: (i) debts are restructured or discharged in any form, including payment of a share of the debt (a minimum of 20% is required only for piecemeal liquidation plans), transfer of assets, assignment of shares or notes; (ii) creditors can or must be divided into different classes, with different treatment. The company can continue to trade for up to four months under the supervision of a Judicial Commissioner appointed by the Court, while the proposal and the plan are being prepared. New loans and any acts exceeding ordinary management must be approved by the Court. Pending contracts can be suspended or terminated by the company with the authorization of the Court. The proposal is approved by creditors with the required majorities. The Court confirms the proposal, which is then binding for all pre-petition creditors.

Simplified concordato – This special form of concordato can be accessed only upon the outcome of the negotiated composition. This is a liquidation-only arrangement, as it must follow the asset sale scheme, which can, however, provide the sale of the business as a going concern. The proposal is not subject to the approval of creditors (who can only file objections) and is instead confirmed directly by the Court.

Restructuring plan subject to approval (so-called "PRO") – The debtor can make a proposal to the creditors which must be approved unanimously by the classes, but which will allow to distribute the proceeds disregarding the absolute priority rule. The proposal must in any case offer a recovery to creditors not lower than the alternative of the judicial liquidation. Many provisions of the concordato preventivo apply, but there is no limitation to the ordinary course of business during the procedure.

GERMANY

The insolvency plan procedure – While regular insolvency proceedings serve to satisfy a debtor's creditors, the main purpose of an insolvency plan is to make arrangements for the survival of the business.

It should be noted, however, that the insolvency plan must place the creditors in the same economic position as they would be in alternative regular insolvency proceedings. This must be demonstrated by means of a settlement calculation.

In the insolvency plan, certain provisions of the Insolvency Code may be repealed or modified, or creditor's claims may be reduced or deferred.

The proceedings begin with the preparation and submission of the insolvency plan by the debtor or the insolvency administrator.

The insolvency plan is summarily examined by the insolvency court after it has been submitted.

For the insolvency plan to be accepted, the majority of the voting creditors must agree. Creditors with the same legal position are divided into groups. Voting on the plan shall take place separately in the respective groups. Insofar as individual creditor groups refuse their consent, although they are not expected to be worse off because of the insolvency plan and the majority of other creditors consent, the consent of these groups can be replaced by the court.

After acceptance of the insolvency plan by the creditors and the debtor's consent, the insolvency plan still requires confirmation by the insolvency court and then enters into force.

Self-administration proceedings – The self-administration procedure is a special type of procedure within insolvency law.

In self-administration proceedings, the debtor is entitled to manage and dispose of the insolvency estate under the supervision of an administrator. The power of administration and disposal does not pass to an insolvency administrator as in other types of proceedings.

One of the prerequisites for self-administration proceedings is the submission of a financial plan covering a period of six months and containing a description of the sources of finance by means of which the continuation of ordinary business operations and the coverage of the costs of the proceedings during this period are to be covered.

BOX 3 – CONTINUED

In addition, the debtor must provide evidence that all obligations under insolvency law are fulfilled.

Protective shield proceedings – If the debtor fulfills the general conditions for access to self-administration, is only overindebted and not yet illiquid and, moreover, the debtor can credibly prove, that reorganization is not obviously hopeless, the debtor may apply for protective shield proceedings. The advantages of this type of procedure are that the debtor can choose the administrator himself, work out the insolvency plan and start restructuring with the support of the administrator during the preliminary proceedings. During this period, the debtor is also safe from any creditor intervention. The protective shield proceedings end when the insolvency proceedings are opened. The proceedings are then continued as insolvency plan proceedings under self-administration. The proceedings usually end with the acceptance of the insolvency plan.

FRANCE

French Commercial Code provides 3 different judicial restructuring frameworks: safeguard proceedings, reorganization proceedings and judicial liquidations. These 3 proceedings entail the following principles: (i) prohibition to pay any debt that arose before the opening judgment ("freeze" of liabilities); (ii) stay of the actions and proceedings against the debtors; (iii) stay on termination of contracts based on payment default, (iv) stay on enforcement measures.

Safeguard proceedings – Directors of a company that is experiencing difficulties that it cannot overcome but is not yet insolvent may apply to the Court for the opening of a safeguard proceeding. The opening judgement starts a period (up to six months) known as the "observation period" (renewable up to a maximum of 12 months) during which the company will negotiate with its creditors a rescheduling or a waiver of debts arising before the opening judgment. The Court appoints a judicial administrator responsible for supervising or assisting directors and for drawing up the safeguard plan and a creditors' representative in charge of collecting the creditor's claims prior to the opening judgement and verifying the debtor's liabilities. The safeguard plan is presented to the Court for approval.

Reorganization proceedings – Directors of an insolvent company must apply for the opening of a reorganization proceeding within 45 days of the occurrence of the insolvency. The opening judgement of the reorganization proceedings starts an "observation period" of a maximum of six months (renewable up to a maximum total duration of 18 months). The Court appoints a judicial administrator responsible for assisting directors or manage the company and a creditors' representative with the same mission as for the safeguard proceedings.
If it is not possible to implement a continuation plan, the judicial administrator may issue a call for tenders in order to sale the company's business in the framework of a disposal plan which must seek the following goals: (i) to maintain the debtor's business, (ii) to preserve jobs and (iii) to pay off liabilities. The scope of the deal only includes assets, and the debts are excluded. The Court appoints the purchaser and its choice is based on the seriousness of the candidate, the continuation of the activity, the price offered and the number of the jobs to be taken over.

BOX 4 – EVICTION OF DIRECTORS

FRANCE

In "mandat ad hoc", conciliation and safeguard proceedings directors may be evicted in accordance with general law and statutes. In reorganization proceedings, the adoption of the continuation plan by the Court may be conditional on the eviction of the directors. For this purpose, the Court may withdraw the voting rights of a shareholder director.

ITALY

The decision to access a preventive restructuring framework remains "on an exclusive basis" with the directors, who cannot be revoked starting from the day the resolution is entered in the companies' register.

GERMANY

In the case of a managing director, a distinction must be made between the contract of employment and the managing director's position as a statutory organ of the company. The dismissal of managing directors from the position of organs is also the responsibility of the shareholders in the event of insolvency. The contract of employment, on the other hand, can be

CONTRIBUTORS:

Mana Rassouli

ADVANT Altana

mana.rassouli
@advant-altana.com

Heinrich Meyer

ADVANT Beiten

heinrich.meyer
@advant-beiten.com

Fabio Marelli

ADVANT Nctm

fabio.marelli
@advant-nctm.com