

Coronavirus and directors' liability for corporate debts

Madrid, May 2020

Since the declaration of the state of emergency on 14 March 2020, the Spanish government has been adopting exceptional legal measures to help companies face the hardship; some of them have an impact on directors' specific obligations upon the occurrence of an event of compulsory dissolution or the insolvency of a company¹, namely:

- (i) Directors' obligation to call a GSM within two months of the occurrence of an event of compulsory dissolution will be suspended until the end of the state of emergency².
- (ii) If an event of compulsory dissolution occurs during the state of emergency, directors shall not be liable for corporate debts incurred before it ends³.
- (iii) As regards compulsory dissolution due to an equity drop below fifty per cent of the share capital, (a) losses incurred in financial year 2020 will not be taken into account for calculating the equity drop and (b) losses incurred during financial year 2021 will only trigger the directors' obligation to call a GSM for it to dissolve the company or remedy the situation within two months of the year end⁴.
- (iv) Insolvent debtors will not be obliged to file for voluntary insolvency until 31 December 2020⁵ and courts will not consider applications for compulsory insolvency filed by creditors between the declaration of the state of emergency (14 March 2020) and 31 December 2020⁶.

These legal measures are no doubt reasonable, but despite them in the months and years to come it will be more important than ever that companies and directors pay attention to the fiduciary duties and potential liability of the latter and for this reason it seems interesting to summarize a recent judgment of the Madrid Court of Appeals (MCA)⁷ about directors' liability for corporate debts incurred after an equity drop triggering the compulsory dissolution of the company.

¹ According to the Spanish Companies Act, directors are jointly and severally liable for their company's debts incurred after the occurrence of an event of compulsory dissolution (i) if they fail to call a general shareholders' meeting (GSM) to address the situation within two months of the date when they knew or should have known about the event or, (ii) in case the GSM is not held or it does not pass the appropriate resolutions, if they fail to request the judicial dissolution or the declaration of insolvency of the company, as appropriate, within two months.

The reduction of the company's equity below fifty per cent of its share capital as a result of losses is an event of compulsory dissolution.

According to the Spanish Insolvency Act, directors must file for insolvency within two months of the date when they knew or should have known about the insolvency of the company.

² Article 40.11 of the royal decree-act 8/2020 of 17 March.

³ Article 40.12 of the royal decree-act 8/2020 of 17 March.

⁴ Article 18.1 of the royal decree-act 16/2020 of 28 April. Note that nothing is said about companies whose financial year does not end on 31 December.

⁵ Article 11.1 of the royal decree-act 16/2020 of 28 April. However, companies are entitled to file for voluntary insolvency.

⁶ Article 11.2 of the royal decree-act 16/2020 of 28 April.

⁷ Judgment of the Madrid Court of Appeals nº 586/2019 of 10 December 2019.

The case is as follows. In 2007 a company incurred losses that reduced its equity below fifty per cent of its share capital. As the directors did not call a GSM within two months for it to take the appropriate actions, the court of first instance found all of them jointly and severally liable for a corporate debt incurred in 2008, despite the fact that one of the directors had resigned in 2009, while the debt had not been judicially declared until 2011. The first instance judgment was challenged before the MCA, which dismissed the appeal for the following reasons:

- (i) The date to determine whether a debt is incurred before or after the occurrence of an event of mandatory dissolution is that on which the debt arises, rather than the date on which it becomes payable or is declared by a court⁸.
- (ii) Mere knowledge by a creditor that its debtor company is in financial or economic distress or even insolvent at the time its claim arises does not prevent it, *per se*, from seeking the directors' liability. On the contrary, a creditor that is aware of such circumstances can legitimately rely on the directors' liability (a sort of *legal guarantee*) in case they do not discharge their duty to timely call a GSM. The conclusion would be different if the creditor also held control of the company when the debt arose (for instance, as a "dominant or relevant" shareholder), as that would show that it accepted to bear the risk of the company's insolvency and, thus, suing the directors would amount to bad faith⁹.
- (iii) Ignorance by a director that an event of compulsory dissolution has occurred does not release him or her from being liable for the debts incurred by the company, for the duty of diligence of every director requires being aware of the corporate matters and, in particular, of any event of mandatory dissolution. The degree in which a director is actually involved in the management of a company or the fact that a director has in practice a mere advisory (as opposed to an executive) role cannot exclude his or her liability either, for the internal allocation of functions amongst directors is irrelevant *vis-à-vis* third parties, including creditors in particular.
- (iv) Undercapitalisation of a company is an event of compulsory dissolution even when the company is not insolvent (a company may be undercapitalised but solvent, and vice versa¹⁰) and triggers directors' obligation to call a GSM to dissolve the company or remedy the situation despite the fact that filing for insolvency may not be possible.

Lastly, it is important to bear in mind that the fact that directors tried (to a greater or lesser extent) to overcome the distress of their company does not eliminate their liability for failing to (i) call a GSM and, if applicable, (ii) seek the judicial dissolution of the company or file for insolvency¹¹. This because directors' liability does not require creditors to prove causality nor the damage itself, but only the breach by directors of the mentioned legal obligations¹².

⁸ Judgment of the Supreme Court n° 151/2016 of 10 March 2016.

⁹ Judgments of the Supreme Court n° 207/2018 of 11 April 2018 and n° 733/2013 of 4 December 2013.

¹⁰ Judgments of the Supreme Court n° 269/2016 of 22 April 2016, n° 275/2015 of 7 May 2015 and n° 122/2014 of 1 April 2014.

¹¹ Judgment of the Barcelona Court of Appeals n° 2357/2019 of 17 December 2019.

¹² Judgment of the Madrid Court of Appeals n° 515/2019 of 4 November 2019.