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High-level overview of managers' responsibilities in times of financial distress

LUXEMBOURG PRIVATE LIMITED LIABILITY COMPANIES

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Background to this overview

The below overview is deemed to be a high-level overview providing the general outlines of the legal Luxembourg framework applicable to the members of the management board in private limited liability companies (*sociétés à responsabilité limitée*) (an "**SARL**") in times of financial distress.

The discussion below is based on the unfortunately ever more frequent context of a Luxembourg incorporated SARL facing severe financial difficulties brought about by a combination of rapidly increasing operational costs due to the current energy crisis hitting the European Union and an ensuing inability to pay back its debt when it has become due under loan agreements the company has entered into.

In this respect, the overview is only meant to provide an initial orientation regarding such managers' duties. It is therefore not purported to be an in-depth legal analysis focusing on particular issues having arisen in the above referred-to context. Consequently, more in-depth advice on a case-by-case basis would have to be sought should particular questions and issues arise in a concrete context.

General due diligence obligations of the managers of an SARL

In the context of a severe liquidity crisis, the managers of an SARL must first assess the company's financial situation and the potential solutions with regard to the non-performance of the company's obligations and try to mitigate the financial impact of the crisis.

The duties of the managers can be described as being based on the following principles.

Managers are obliged to (i) act as a reasonably prudent person, (ii) manage the company's business in good faith (*bonne foi*) and with due care, in a competent, diligent, prudent and active manner and in the company's interest as well as (iii) refrain from doing anything that does not fall within the company's corporate object.

Furthermore and in accordance with the specific nature of the liquidity shortage the company is facing the company's managers are required to act swiftly in order to protect the company's interests.

Initial assessment of the company's financial health

More specifically, this means that without undue delay the managers must assess the company's liquidity position, any obligations ensuing thereof and the abilities to meet them.

In this respect, the first step is to analyse the company's cash flow position based on recent management accounts. As this initial step often proves critical in order to successfully combat the liquidity shortage crisis, an obligation might arise in accordance with the circumstances of the case to involve internal but also external advice of the company's financial and legal advisors with an aim to identify and ultimately avert any potential solvency issues which could lead to bankruptcy.

This means that managers must identify in addition to the more prominent and upcoming financial commitments any off-balance sheet commitments (such as guarantees granted to affiliated parties or any other type of security interests).

On the other hand managers must also consider the potential enforcement of any pledge or any other type of guarantee or security contract that the company could benefit from. Should this initial assessment lead to substantial concerns that the liquidity crisis cannot be averted, or at least considerably mitigated, by resorting to the enforcement of security rights or any other contractual payment obligations other parties have vis-à-vis the company a more in-depth assessment phase must be initiated.

In-depth due diligence contractual obligation assessment

Once the initial assessment has been concluded a more detailed analysis must be performed with the aim to identify specific contractual obligations of the company which are likely not to be fulfilled due to the liquidity shortage.

In this respect, it must be analysed whether in any given contractual framework the company is a party to:

i. agreements may be terminated unilaterally;

ii. any breaches can be cured or mitigated; and

iii. whether there are any force majeure or contractually agreed adverse change clauses which could be applied by the company.

Furthermore, with respect to pending litigation or disputes managers should consider whether alternative means of protecting the company's interests can be resorted to. In some cases this might mean the abandonment of litigation if the managers conclude that the chances of a ruling against the company are high and that settling would be likely to generate less costs.

Government subsidies and bank initiatives

Given that the current energy crisis has been causing considerably increased operational costs for many businesses in the EU it must furthermore be assessed whether any state subsidies or measures aimed at providing financial relief to businesses which are severely impacted by the crisis exist and could be applied for.

Even if such schemes do exist the various categories of state aids often depend on the type of company involved and its economical activities as well as its position and relevance in the market. In this respect, the managers have an obligation to seek, to the extent necessary, external advice in order to ascertain if any state aid schemes could be resorted to so that appropriate and timely action can be taken by applying for the most relevant forms of assistance. Any failure to do so by the managers of a company facing financial difficulties could even be considered to be a gross misconduct on their part. Ultimately, this could lead to consequences with respect to general managers' liability.

However, unfortunately, mere holding companies are frequently excluded from the scope of relief measures such as direct financial support, the provision of guarantees, tax relief schemes or any other employment or social security aid.

In addition to state aid, some commercial banks have taken initiatives to support the economy and provide some breathing room to companies facing financial difficulties. In this respect, certain EU commercial banks may grant a suspension of loan repayments for a period of up to six months (to be negotiated) at the express request of the borrower. In any event, should the financial crisis mainly stem from due payment obligations with respect to a specific loan agreement concluded with a particular bank the managers of the company have an obligation to contact the bank to request a suspension of loan repayments or to at least re-negotiate part of the loan agreement in order to obtain some level of temporary payment relief. Should such re-negotiations prove to be unsuccessful the managers would subsequently need to assess whether there might be a possibility to sell any real estate (the purchase of which had been made by way of the funding obtained via the loan) at a market price exceeding the payment obligations under the loan agreement. Thus, although depriving the company of its main economical activity, one might at least reduce the risk of complete cessation of payments and a subsequent bankruptcy filing as depicted under the following section.

Shareholder support

If the above depicted approach proves to be insufficient to allow the company to meet its obligations, the managers should consider requesting the company's shareholders to provide additional funding. Such funding could be provided via equity, i.e. by way of a share capital increase or a contribution to the so-called account 115 of the Luxembourg standard chart of accounts (*apport en capitaux propres non rémunéré par des titres*). In some instances it might be preferable to resort to the provision of debt, i.e. the granting of direct loans or the subscription to debt securities issued by the company.

Generally speaking, shareholders do, however, not have a statutory obligation to (i) contribute more than they initially contributed at incorporation or (ii) grant additional funding to the company. However, in specific cases shareholder agreements might exist and should be reviewed in order to ascertain whether any contractual obligations on the part of certain shareholders could be applied in order to obtain additional financial support for the company.

In contrast to Luxembourg public limited companies (SAs) there is, however, no general obligation for the managers of an SARL to convene a shareholders' meeting in situations in which the net assets of the company have fallen below a specific percentage of the company's share capital.[1]

1 Article 480-2 of the Luxembourg Companies Law is only applicable to public limited liability companies and partnerships limited by shares.

Obligation to file for bankruptcy

Once the company has ceased payments under the bankruptcy conditions of the Luxembourg Commercial Code the managers have the obligation to acknowledge and file for bankruptcy within one month from the date of the cessation of the payments.

The conditions for the opening of such bankruptcy filing are the following ones, which must be met cumulatively for an entity to be considered bankrupt:

i. it can no longer pay debts as they fall due (i.e., it is in a situation known as cessation of payments) and

ii. it is no longer being granted credit.[2]

The cessation of payments means the debtor is unable to meet its commitments. It implies that unpaid debts are certain, liquid and have fallen due on the day on which the bankruptcy judgment is delivered. It is not necessary that the debtor has ceased all its payments. The only relevant issue is to establish whether the default in payment to certain creditors is temporary or permanent. In the latter case, the existence of a single debt may lead to the cessation of payments. On the other hand, temporary financial difficulties are normally not sufficient.

The loss of creditworthiness may result from the inability to raise credit or from the creditors' refusal to accept any further delay in paying back the debt.

2 Article 437 of the Luxembourg Commercial Code.

Duties of managers in financial difficulties

General principle

As a general principle, the managers of a Luxembourg SARL are not liable for the debt incurred by the company. However, it is the managers' general duty to perform their duties in the best interests of the company, and they may be held liable if they fail to act in a prudent and diligent way and caused damages to the company (contractual liability) or to third parties (tort liability), as explained above.[3]

Specific provisions

The amended law of 10 August 1915 on commercial companies (the "**Luxembourg Companies Law**") includes specific provisions on the duties of directors/managers of Luxembourg companies in financial difficulties.

The Luxembourg Company Law provides for specific criminal offences, such as the failure to publish the balance sheets and compulsory reports or the payment of fictitious dividends.[4]

The main legal provisions dealing with the personal liabilities of managers in cases of bankruptcy are however laid down in the Luxembourg Commercial Code.

As mentioned above, the managers must file for bankruptcy within one month of the date that the company ceased its payments.[5] Failing that, they may be criminally liable for negligent or fraudulent bankruptcy.[6]

3 Article 710-16 in conjunction with article 441-9 of the Luxembourg Companies Law.
4 Article 1500-6 of the Luxembourg Companies Law.
5 Article 440 of the Luxembourg Commercial Code.
6 Articles 573 following of the Luxembourg Commercial Code.

If a manager has contributed to the bankruptcy of the company by a serious offence the court may declare that such a manager is to be prohibited from exercising directly or indirectly any commercial activity as well as any function of director, manager, auditor or any function implying the power to undertake obligations on behalf of a company.

Furthermore, any manager may be declared personally bankrupt in cases of bankruptcy of a company if they have used the company to act in their own personal interest, have used the company's assets as if they were their own or have carried on, in their own personal interest, any loss-making activity that would inevitably lead the company into bankruptcy.[7] In this respect, it is irrelevant whether or not the manager was lawfully appointed by the company or has been acting in such a capacity.

The court may decide that the managers of a company are liable for the outstanding debts of that company if gross negligence by the managers has contributed to the bankruptcy and if the assets of the company do not allow the payment of all the company's creditors. Such gross negligence is analysed on a case-by-case basis by the court.

The same liability applies in cases in which one or several managers have misused their authority to continue any loss-making activity of the company for their own personal benefit and without taking reasonable measures to avoid bankruptcy.

Not only does the above rule apply to managers who were in office at the moment the company was declared bankrupt but usually also applies to any managers who contributed to the company's bankruptcy through their actions in the past, irrespective of the managers' having been lawfully appointed or only having acted as *de facto* managers.

7 Article 495 of the Luxembourg Commercial Code.

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