Galicia

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Sound legal decisions in uncertain times

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Upon the wake of the COVID-19 pandemic, businesses may experience tightening of cash, breach of financial ratios or other financial hardship. Consequently, besides trying to seize opportunities to preserve cash, businesses may begin negotiations to restructure its debt, extend maturities, free reserves and collateral, etc. However, in a genuine spirit of self-preservation, business' ill-advised decisions could backfire or result in liability to them or their managers.

Certain actions or omissions carried out at the twilight of insolvency (potentially, up to three years before insolvency declaration) may result in liability (civil or criminal) for the business or its managers. The goal of said liability is to elicit businesses to take a fair and honest approach to their restructuring and to prevent bad-faith transactions in the midst of their financial distress.

Causes of liability

Criminal liability –which extends to directors and officers— may arise, generally, when the business:

- deliberately aggravates its ability to pay,
- manages its accounting in a way that prevents others from knowing the business' true financial condition, including destroying, altering or hiding of books and records, or
- fails to file tax returns for more than twelve months or fails to pay taxes withheld from third parties.

To that extent, businesses should clean up its accounting records, if needed, and refrain from using tax funds as cash flow.

Civil liability (which may overlap with criminal liability) arises from transactions entered into by the company. This liability can also be extended to directors and officers, who, in turn are subject to an additional liability regime.

As for the company's transaction, it should avoid:

- transactions with the intent to defraud creditors,
- gratuitous transactions,
- making payments-in-kind,
- transactions that are not in the ordinary course of business, including, especially, debt remissions and prepayments, and
- granting collateral or additional collateral if not originally contemplated in the transaction documents.

As for the D&O actions, they should refrain from:

- voting at meetings or making decisions with respect to a business' assets with a conflict of interest,
- knowingly favoring a shareholder or group of shareholders to the detriment of all other shareholders,

- obtaining an undue economic benefit for themselves or a third party as a result of their position, or
- ordering or causing the omission or alteration of recording a business' transactions or accounts to hide the true nature of a business' transaction.

To increase their credibility and reinforce that their decisions were consistent with legal regulations, managers may retain independent financial advisors for them to prepare business forecasts that will serve as the basis for their decisions. Likewise, business shall maintain open lines of communication with their creditors, appointing to that task someone different than the ultimate decision-makers.

Conclusions

The financial distress caused by the COVID-19 pandemic to an otherwise healthy business is problematic enough. Decision-makers should be careful in the way they conduct the business during these uncertain times. Especially, managers should become familiar with the insolvency legal framework to make sound financial decisions that not only maximize cash flows or improve their debt profile, but that will not trigger liability for the business or its managers.

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