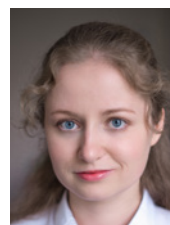


Liability Transferred After M&A: How New Management Can Avoid Risks



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An important indicator of success for M&A is how smoothly control of it was transferred. The acquisition of a company often involves appointment of new management. What should be considered during transfer of control, and how can risks borne by new management due to the mistakes of their predecessors be avoided?

Corporate and insolvency laws of Ukraine envisage several specific cases of personal liability for directors (and other managers) for obligations of the company or its shareholders. Though in some cases to avoid liability it is sufficient that the director does not take clearly unlawful actions (for example, does not include false information that could lead to illegal payment of dividends into documents of the company), in other cases liability arises for failure to comply with specific procedures which the director may not be aware of. Such requirements are particularly related to monitoring of net assets and the status of the firm's solvency.

As tough quarantine measures to prevent the further spread of COVID-19 are ongoing and, at the same time, industrial production and business activity in general are declining, cases of low companies' assets and risks of personal liability for top management will occur more and more often. It should also be noted that the risks mentioned are relatively new and could still be beyond the scope of standard due diligence. Here we would like to draw your attention to some transitional situations regarding management's liability, which could happen during M&A.

Case 1. Decrease in net assets. The former director didn't initiate a general meeting of shareholders regarding a significant decrease in the company's net assets. In the meantime, the company is acquired by new

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shareholders and a new director is appointed. The business is not going well, and a few years later the company is declared bankrupt. Such situation creates the risks of applying subsidiary liability for obligations of the company not only to the ex-director but to the new one.

The liability may arise on the base of para. 3, 4 Article 31 of the Law *On Companies with Limited and Additional Liability*. It is prescribed that if company's net assets decrease by more than 50% compared to their amount as of the end of the previous year, the director shall initiate a general meeting of shareholders, which shall take place within 60 days from the date of such decrease. The agenda of the general meetings should include issues regarding measures to improve the company's finances, decision on decreasing the charter capital or the company's liquidation. In the event that the obligation to convey the meeting was not fulfilled and the company was declared bankrupt within 3 years from the date of significant decrease of the net assets, the director personally takes subsidiary liability for the company's debts. If the company has an executive body with more than one director then all the members jointly and severally will share the mentioned liability.

This rule leaves many questions, especially in the case of M&A when the director

was changed before the end of 60-day term for convening the general meeting. At first it's uncertain as to how to define the date of the decrease in net assets – as of the date of regular financial statement that reveals such decrease (which would be logical) or also possible due to unclear wording of the law – at the moment when the exact transaction (payment) occurred, which resulted in a significant decrease of net assets on a specific day occurs somewhere in the middle of the reporting period.

Second, the timeframes for convening the meeting must be respected. Unless otherwise prescribed by the company's charter, the director must notify the shareholders at least 30 days before the scheduled date for the meeting. Taking into account the fact that regular financial statements are usually prepared within two weeks of the end of the reporting period, and 2-5 days may be required for delivery to the shareholders of the mail correspondence about convening of the meeting, the director actually has no more than 10 days out of the total 60-day term for making notifications about the meeting.

Third, the law does not regulate how the obligation to convene the meeting (and respective liability) is allocated if the director was replaced before the deadline. Also, there is no reason to believe that for the new director, the 60-day period should begin anew. However, in view of the significant risk (personal liability for the company's debts), the new director is advised to receive complete information on the status of the net assets as soon as possible, and to take all possible actions for the prompt convening of the general meeting (if required).

Shareholders can mitigate this risk for the new director if they hold the general meeting promptly (if all shareholders agree to participate and vote on a 30-day term for

notice can be reduced), taking into consideration measures regarding reduction of the net assets and confirming that all necessary measures were taken by the new director.

Case 2. Significant transactions. During M&A almost uninterrupted economic activity was maintained by the company. After the change of ownership and management, the company continues to conclude and execute contracts, some of which can reach thresholds of significant transactions. So as to avoid personal liability for violating procedures on concluding significant transactions new management should promptly check all necessary corporate approvals, establish monitoring of significant transactions and arrange all new approvals in a timely manner.

The Law On Companies (Art. 44-45) places joint and several liability on the guilty managers for damages caused to the company for violation of the procedures on making significant transactions. Unless otherwise provided under the charter, the decision on approval of a transaction for the amount more than 50% of net assets as of the end of previous reporting period should be adopted by the general meeting of the shareholders. In the event that one significant transaction could be concluded instead of several similar transactions, each such transaction is regarded as significant.

The law does not specify what would be considered a violation of the procedure for making significant transactions. However, as the director is responsible for initiating general meetings, signing a contract for a significant transaction without previous notice and approval from shareholders would likely be considered a violation. It is advised that a company's documents specify procedures which should be followed for significant transactions with distribution of respective

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liability among the director and other responsible persons.

There is also an "external" aspect of entering significant transactions, that of receiving corporate consent from counterparties. The lack of the necessary consent leads to the consequences of a void transaction. And if such a transaction continues to be executed after the appointment of new management, they may be held liable for the losses of the company too.

Therefore, it is important for new directors, accountants, sales managers, and other responsible managers of a company to maintain the monitoring of significant transactions and organize their prompt approval. The law does not require the re-issuance of corporate approvals which were provided by the general meeting of previous shareholders. However, re-approval of the most important agreements with the participation of new shareholders may be reasonable in order to avoid any disputes in the future.

Another feasible step would be adaptation of the charter (with specifying transactions that require the consent of the general meeting). In the event of a disputed transaction being made by the former director immediately prior to acquiring control without the necessary authority, shareholders have,

through their decision, the opportunity to approve such transactions post factum or to hold the former director liable for losses caused to the company.

Case 3. Self-bankruptcy. Despite insolvency, the ex-director did not file for the company's bankruptcy, which creates the risks of his personal joint and several liability for failing to meet the claims of creditors. If the insolvency status continues after M&A and the new director does not file for bankruptcy too, the same risks may be also applicable.

According to Article 34 of the *Code of Ukraine on Insolvency Procedures* (in force since 21 October 2019), in the event that the satisfaction of the claims of one or more creditors will make it impossible to fulfil monetary obligations to other creditors (the threat of insolvency) the debtor is obliged, within a period of one month, to apply to the commercial court for self-bankruptcy. If the debtor violates these requirements, he becomes jointly and severally liable for failing to meet the creditors' claims.

The new director, who was appointed within such a 30-day period or later, can be held liable for not filing for self-bankruptcy as the law has no clear exemption for such transitional cases. Moreover, there are different approaches to defining the threat of insolvency. Even a fully operational company that obtained a loan from its parent company may be called insolvent. In order to avoid applying serious liability under such formal criterion to the new director (who did not have any connection to deterioration of the company's financial performance), it is recommended to include detailed analysis of the company's solvency issues and compliance with self-bankruptcy procedures into the audit before M&A takes place.

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