

# COVID-19 Consequences for corporate finances

BMWC

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# INTRODUCTION

We believe that it is no longer necessary to emphasize that the global spread of the disease COVID-19 has caused numerous challenges for entrepreneurs and employers in organizing work processes and maintaining liquidity. It is certain that due to the current situation, a large number of companies will face some financial difficulties and will face problems related to financing their further business and meeting their obligations to creditors.

Many employers have already faced work stoppages due to the obligation to comply with the prescribed measures to combat the coronavirus infection. Those who were not required to discontinue work, face to day, reduced intensity of work, inability to continue production due to lack of raw materials, cancellation of orders and contracted jobs, and numerous other challenges.

All of the above can very easily put a company into a state of lack of liquidity and insolvency. Therefore, in order to provide these companies and their management with the necessary guidance regarding their legal obligations, we provide helpful advice below on what to do and how to proceed if this occurs.

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## Relevant regulations

- ▶ Companies Act (NN 111/93, 34/99, 121/99, 52/00, 118/03, 107/07, 146/08, 137/09, 125/11, 152/11, 111/12, 68/13, 110/15, 40/19, further: "**ZTD**");
- ▶ Law on Financial Management and Pre-Bankruptcy Settlement (NN 108/12, 144/12, 81/13, 112/13, 71/15, 78/15, further: "**ZFPPN**");
- ▶ Bankruptcy Law (NN 71/15, 104/17, further: "**SZ**").



# Business management of the company

First of all, it should be emphasized that in accordance with the relevant legal regulations, the management or executive directors are the ones (depending on the form of company) who conduct the affairs of the company in accordance with the social contract or statute, decisions of the members of the company, and mandatory instructions of the assembly and the supervisory board, if the company has one.

The members of the management board must manage the affairs of the company with the attention of an orderly and conscientious businessman.

As a consequence of a certain independence in the work of the members of the Management Board, their personal liability for damages also appears in case they violate their duties determined by the relevant legal regulations.

Thus, ZTD explicitly prescribes the duties of the management in case of loss, over-indebtedness or inability of the company to pay, and also regulates the issue of responsibility of the management acting in contravention of these duties.

Also, ZFPPN contains provisions on obligations and actions of the management in case of occurrence of insolvency.



# What are the duties of management in the event of loss, debt or inability to pay?

The answer to this question is contained in Article 251 ZTD which states the following:

- 1) If, in the preparation of the annual **or other** financial statements, it is otherwise established that there is a loss in the company of half of the share capital of the company, the management must **immediately convene a general assembly** of the company and report it.
- 2) If the company is unable to pay or over-indebted, the management must, without delay, and no later than three weeks after the occurrence of the reason specified by the special law as the reason for initiating bankruptcy proceedings, **request the opening of such proceedings**.
- 3) After inability to pay or over-indebtedness arises, the management **is not allowed to make payments**. This does not apply to payments which are then made with the care of an orderly and conscientious businessman.

With regard to the conduct of the members of the board of directors themselves, they are obliged to conduct the affairs of the company with the attention of an orderly and conscientious businessman, and if they breach their obligations they are liable for damages to the company as joint and several debtors.

The members of the Management Board are particularly liable for damages if, contrary to the provisions of ZTD, they make payments after the inability of the company to pay, or after the indebtedness of the company occurs.

The said liability exists even if such action was approved by the Supervisory Board, and the exclusion from liability for damages exists only if the actions of the members of the Management Board are based on the decision of the General Assembly of the company.

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## Inability to pay and over-indebtedness

For an entrepreneur who becomes unable to pay or who becomes over-indebted, we say that he is **insolvent**. But what exactly does that mean?

According to the provisions of ZFPPN and SZ, an entrepreneur is **unable to pay** if:

- I. he cannot fulfill his monetary obligations **more permanently**; the mere fact that the entrepreneur has settled or is able to settle in full or in part the claims of some creditors does not in itself mean that he is capable of payment;
- II. If it is recorded in the Register of the payment order maintained by the Financial Agency that there are outstanding payment bases for a period **exceeding 60 days**, and which should have been collected from any of the entrepreneurs accounts on the basis of valid payment grounds without further consent of the entrepreneur;
- III. if he has not paid **three consecutive salaries** belonging to the workers under an employment contract, rulebook, collective agreement or special regulation, or under another act governing the employer's obligations to the workers.

An entrepreneur is considered **over-indebted** if the value of his assets does not cover his existing liabilities, but he will not be considered to be over-indebted if, by the circumstances of the case, it can be reasonably assumed that he will with the continuation of business fulfill his obligations on maturity.



# What does a lack of liquidity mean and when does it occur?

In running the business, management is required to take all necessary measures to ensure the liquidity and solvency of the company and to manage the assets and liabilities of the company so that it is able to meet all its obligations.

The duty to supervise the liquidity and solvency of the company lies with the supervisory board, if the company has one.

Insolvency occurs when a company or an entrepreneur is unable to meet the monetary obligations that mature **within a certain period of time**.

An entrepreneur is considered illiquid if:

- I. he is more than 60 days late in fulfilling one or more financial obligations exceeding 20% of the amount of its current liabilities disclosed in the annual financial statements for the previous financial year, or
- II. he is more than 30 days late in payment of the salary in the amount of the agreed salary and payment of taxes and contributions, which he is obliged to calculate and pay together with the salary.



# How to deal in case of illiquidity of the company?

In case of illiquidity of the company, the management may not make any payments other than those **necessary for regular operations**.

The question naturally arises, what are the payments necessary for regular business?

The answer to this question is provided by ZFPPN, which, in Article 17, cites as necessary the following payments:

- I. priority claims,
- II. workers' salaries from the day the pre-bankruptcy settlement procedure is opened,
- III. operating costs (electricity, water, etc.),
- IV. procurement of goods and services necessary for regular business operations,
- V. value added tax, excise duties, contributions and other taxes which must be levied and paid by the company in accordance with the regulations,
- VI. costs of proceedings before public bodies,
- VII. the cost of preparing the documentation required to initiate and implement the pre-bankruptcy settlement process.

Furthermore, the management in a state of illiquidity of the company is **not allowed** to take actions that would result in damage or putting the creditors in an unequal position.

Such actions are particularly considered to be:

- reallocation of cash and financial flows to another person,
- lending,
- payment of an advance on profit or profit,
- dividend payment,
- transferring rights to third parties, especially affiliates.





## What if management acts contrary to the provisions of ZFPP?

In the event that the management acts in contravention of the provisions of Article 17 ZFPPN, that is, if in a state of illiquidity it makes any other payments than those necessary for regular operations, the entrepreneur will be held **liable for misdemeanors**.

The fines for the said offense are as follows:

- ▶ from 10,000.00 to 1,000,000.00 kuna for a legal entity,
- ▶ from 1,000.00 to 50,000.00 kuna for a responsible person in a legal entity.



# Paying out of profit in case of illiquidity caused by the pandemic of the Coronavirus

Given the uncertainty in the business caused by the pandemic of the coronavirus, resulting in the reduction or even complete disruption of all economic activities and work processes of many entrepreneurs, it is easily possible that these entrepreneurs will unplannedly enter into a state of illiquidity.

Considering that the peak of the spread of this disease occurs at the moment when many entrepreneurs have concluded the previous business year and adopted certain plans for this business year, and thus probably the decision on the payment of profit for the previous business year, the following questions arise:

- *How to keep work processes healthy and what impact would any liquidity problems be caused by the payment of established profits on the management of companies?*
- *Is it possible to suspend a profit decision already made?*

Of course, it is clear from the above that these are not ordinary business situations, and especially since the profits are still paid in situations where the company has operated with success and when certain plans are made to continue successful business.

However, the situation caused by the global pandemic and the consequent disruption of business as usual will also confront many employers and entrepreneurs with this specific issue.

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What if the decision on the annual financial statements and the payment of profits has not yet been taken?

Article 406 ZTD stipulates that if in the period between the end of the business year and the decision of the members of the company on the annual financial statements it is known to the management or the supervisory board that the assets of the company are significant and not only transient deterioration due to losses or decrease of the share capital, it must exclude profits arising from the income statement in the amount of the impairment loss suffered. Such profit must be transferred to the account of the current business year.



What if the decision to pay a profit has already been made?

As we have already stated, in the event of a company being illiquid, the management may not make any payments other than those necessary for regular operations, and it must also not take any action that would result in damage or disqualification of the creditors.

One such action is considered to be a down payment of a profit or gain.

Thus, if, as a result of this coronavirus pandemic emergency, problems arise for the entrepreneur and he becomes illiquid, and a decision has already been made by the general meeting to pay the profits, then the established profit may not be paid if the company would thereby damage or if this puts its creditors at a disadvantage.

The implementation of a decision to pay a profit contrary to the foregoing would result in a misdemeanor sanction for the company and the responsible person of the company.

Continuing from the above mentioned, the question arises as to what is the position of the case law in the Republic of Croatia regarding the revocation of decisions already made on the payment of profits?

# Court practise

The judgment of the High Commercial Court in Case Pž-4422/02 decided as follows:

*"The General Assembly may, up to the conclusion of the minutes of the Assembly within the meaning of Article 286 (2) and (4) ZTD, revoke its decision made at the same Assembly and replace it with another decision because it is considered that the superseded decision was not valid until finally entered in the minutes and until the notary signs the minutes. Thereafter, the General Assembly cannot change the decision on payment of the dividend."*

The same court in Case No. Pž-3123/01 decided that:

*"The subsequent decision of the General Assembly that the profit will not be paid to shareholders will not be valid, or that the earlier decision on the payment of profit to the shareholders will be repealed."*

In Case No. Pž-4421/02 also the High Commercial Court decided that:

*"The General Meeting of Shareholders may, at the same convocation, revoke the decision it made at that General Meeting, but only until the minutes from that Assembly have been concluded. The decision of the general meeting obliges the company on the day of its adoption, and the subsequent revocation of the decision (e.g. on payment of dividends to shareholders) is not legally valid."*



# Conclusion

It is clear from the previous case law that once a profit decision has been made, it can no longer be subsequently reversed, even if the entrepreneur would find himself in business difficulties as a result of such payment.

However, in all the above cases, the situation is repeated in which at least one of the members or shareholders disagreed with the decision to annul the decision on the payment of profits and brought an action against the same.

Consequently, we believe that such a decision on the annulment of a decision on the payment of profits could still be made, but for such a decision to be valid it would be necessary to make it unanimously by all members of the company.

This would prevent any of the members of the company from subsequently challenging the decision and also make it valid and enforceable.

Of course, as mentioned above, in the event that, after the General Meeting's decision on the payment of profits and the payment itself, the company becomes illiquid, which is not impossible in this extraordinary situation caused by the spread of the COVID-19 coronavirus disease, the company's management may not pay the profit if the company is thereby damaging or placing their creditors in an unequal position. Therefore, in this case, it is certainly necessary to annul the decision on the payment of profits, and the conscientious administration should convene the assembly and include in the agenda of such assembly the decision to annul the decision on the payment of profits.

Finally, we conclude that if a company becomes financially distressed due to unforeseen events caused by the spread of the coronavirus and becomes illiquid, the management is required to suspend all payments (including profits), except for those payments necessary for regular operations. If, however, the company becomes unfit to pay due to the new circumstances, the management is obliged to immediately request the opening of bankruptcy proceedings for the company within three weeks of the inability to pay.

Thus, the emerging circumstances have placed additional challenges on the members of the boards of companies, which are obliged to make even more efforts to run the affairs of the company with the attention of a tidy and conscientious businessman. To try to help members of the boards of companies affected by this pandemic, BMWV will continue to publish such reviews in the hope that it will at least slightly assist the boards in their day-to-day work and decision-making.

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