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Impact of the COVID-19-Pandemic on the use of profits
by corporations

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Impact of the COVID-19-Pandemic on the use of profits by corporations

With regard to and in connection with the economic consequences of the COVID-19-Pandemic, numerous questions of commercial and corporate law arise, which may also have consequences for the scope of action in the utilization of KfW loans and their processing.

Fundamentals

With regard to and in connection with the economic consequences of the COVID-19-Pandemic, numerous questions of commercial and company law arise, which in part also interact with the possibilities of applying for loans under the KfW programmes and the scope for action when using KfW loans. The focus here - also with a view to the corporate calendar - is on questions relating to

- **contractual and statutory restrictions on dividend payments,**
- influence of the Pandemic on **dividend policy,**

- **interaction** between prohibitions on profit distribution when **KfW loans** are taken up and proposals for the appropriation of profits and resolutions on profit distribution,
- **execution** of profit distribution resolutions,
- **duties of action** of the management bodies.

Modified Conditions for KfW Programmes

The relevant **information sheets and general conditions for the KfW Special Programmes 2020 did initially not** include provisions on relative or absolute restrictions on disbursements.

However, **corresponding restrictions** on disbursements or a requirement to impose them on the final borrower **were added at a later date**.

Reference should be made here in particular to **KfW Information for Banks 22/2020 of 9 April 2020**.

The KfW Information is mainly dealing with **adjustments of the lending processes** and funding conditions for the loan programmes 037/047, 075/076 and the KfW Special Programme Direct Participation Consortium Finance, 855.

There are new regulations, among other things, on the conditions that must be met by 31 December 2019 for being eligible for the programmes and those that must be fulfilled at the time of application.

Current regulations, "specification and supplementation" of further funding conditions

With regard to the issue of possible restrictions on the distribution of dividends, which is of interest here, the paper speaks of "**specifying and supplementing**" further funding conditions - in reality, at least some of these should be new regulations. As far as profit and dividend distributions are concerned, the KfW Information states

Profit and dividend distributions during the credit period:

Profit and dividend distributions (the latter only to the extent not prescribed by law) are not permitted during the term of the loan, with the exception of customary market remuneration to business owners (natural persons). This also applies to profit and dividend distribution resolutions already adopted by general meetings.

The relevant **leaflets and other information have been adjusted accordingly** in the meantime. These now provide for a passage of the same wording:

Profit and dividend distributions (the latter only if not required by law) are not permitted during the term of the loan, with the exception of customary market remuneration to business owners (natural persons). This also applies to profit and dividend distribution resolutions already adopted by general meetings.

Rules to be included in loan agreements with final borrowers

It can therefore be assumed that, when granting KfW loans not only under the KfW Quick Loan Programme, but also under Programmes 037/047, 075/076 and the KfW Special Programme Direct Participation Syndicated

Loan, 855, house banks are now **required to include corresponding provisions in their contractual relationships with the final borrowers**, i.e. provisions according to which **profit and dividend distributions** (the latter only to the extent not required by law) **are not permitted** during the term of the loan.

Consideration of the economic consequences of the Pandemic in the preparation and establishment of the financial statements?

Not only against this background, the question arises whether and, if so, how the economic **consequences of the Pandemic are to be taken into account when preparing and adopting the annual financial statements**.

Technical guidance by the IDW

This goes far beyond the questions raised with regard to accounting and auditing and the associated **IDW statements**.

On the subject and content of the IDW statements, see, for example, the Technical Note of the IDW of 4 March 2020: "Effects of the spread of the coronavirus on accounting as of the cut-off date 31.12.2019 and their audit" (*Fachlicher Hinweis des IDW vom 4.3.2020: „Auswirkungen der Ausbreitung des Coronavirus auf die Rechnungslegung zum Stichtag 31.12.2019 und deren Prüfung“*); Technical Note of the IDW of 25 March 2020: "Effects of the spread of the coronavirus on accounting and their audit (Part 2)" (*Fachlicher Hinweis des IDW vom 25.3.2020: „Auswirkungen der Ausbreitung des Coronavirus auf die Rechnungslegung und deren Prüfung (Teil 2)“*); Technical Note of the Technical Committee for Business Valuation and Business Administration (FAUB) of 25 March 2020: "Effects of the spread of the coronavirus on business valuations" (*Fachlicher Hinweis des Fachausschusses für Unternehmensbewertung und Betriebswirtschaft (FAUB) vom 25.3.2020: „Auswirkungen der Ausbreitung des Coronavirus auf Unternehmensbewertungen“*).

Within the scope of the above-mentioned statements, the IDW had come to the conclusion that, as a rule, "the occurrence of the coronavirus is to be classified as a worldwide danger and therefore the consequences for the balance sheet **are only to be considered in financial statements with a cut-off date after 31 December 2019**" (*„dass das Auftreten des Coronavirus als weltweite Gefahr **wertbegründend** einzustufen ist und dementsprechend die bilanziellen Konsequenzen erst in Abschlüssen mit Stichtag nach dem 31.12.2019 zu berücksichtigen sind.“*).

Revival of the liquidity-based solvency test model?

First of all, the question can be raised as to whether in view of the Pandemic, more attention should not be paid again to the model of the **liquidity-based solvency test** as the basis for capital preservation and profit distribution.

Consideration of special effects in the calculation of the net income for the year?

It should also be discussed whether the special effects resulting from the economic consequences of the Pandemic can or **must be taken into account when calculating net income**.

Here, for example with GmbHs, the question arises whether the ban on disbursements of **Section 30, Subsection 1, Sentence 1, GmbHG**, which serves to maintain the share capital, requires that the amount of the shortfall amount shown in the balance sheet determined at the current point in time represents a **deduction item in the net income** for the year in the case of companies which previously had no or only insignificant open reserves and have to cope with slumps in sales or new debts after the effective date of the financial statements.

Consideration of the economic consequences of the Pandemic in the context of profit appropriation?

Furthermore, the question must be asked how to proceed if the **profit was determined correctly**, but the **company's asset, financial and earnings position deteriorated (possibly massively) subsequently**, i.e. after the profit was determined.

If a correct and valid resolution is to be assumed here, it would have to be examined whether such a subsequent deterioration leads to an **automatic elimination or an automatic reduction of the shareholders' claim to the payment of profits**.

Absolute limit on capital maintenance

Finally - at least in the case of considerable "imbalance" caused by the Pandemic - an examination of the **capital maintenance rules**, Sections 30, 31 GmbHG, 57 Aktiengesetz (German Stock Corporation Act) must take place.

Here the point in time of the payment, i.e. the time of the execution of the distribution resolution, is decisive.

Duties of action of the management bodies before the infringement of the capital maintenance rules?

But even **before the absolute limit of the capital maintenance rules is reached**, the executive bodies have to consider and take action, for example in the context of the proposals for the **appropriation of profits**.

Within the scope of the proposals for the appropriation of profits and the subsequent resolution, decisions must also be made as to whether and to what extent amounts are to be **allocated to reserves**.

Even though the law only provides for material requirements for the appropriation of profits to a very limited extent, the question arises as to whether, in the case of proposals for the appropriation of profits and resolutions in companies affected by the Pandemic, **it would not be advisable, based on sound business judgement, to restrict distributions to shareholders** - possibly up to the limits provided for by Section 254 of the Stock Corporation Act - and to allocate to reserves instead, in the **interest of the viability and resilience of the company**.

"Withdrawal" of a proposal for the appropriation of profits?

If a proposal for the appropriation of retained earnings has already been made, the question arises as to whether and under what conditions it can be "**withdrawn**" if deteriorations occur subsequently. In principle, this should be possible.

Refusal to implement a resolution on the appropriation of profits?

Another interesting question is whether and, if so, under what conditions an **executive body can refuse to implement** a resolution on the appropriation of profits, for example if this would endanger the company's viability and resilience, and whether this possibility already exists before the capital maintenance rules come into play.

It should be recalled here - as was already the case with the resolution on the appropriation of profits - that it is largely undisputed that **a breach of fiduciary duty** can exist if the resolution on the appropriation of profits **deprives the company of liquid funds on which it is urgently dependent** in the interest of its continued existence.

The legal concept of unlawful interference (*Rechtsfigur des existenzvernichtenden Eingriffs*) could - at least in extreme cases - also have to be used more frequently in the future.

Reputational issues?

Beyond the requirements of commercial and corporate law, in particular the provisions of stock corporation law, as well as the questions of technical and accounting implementation, the issues dealt with here may also be of **social significance** in the broadest sense.

These can have - possibly massive - economic consequences and have a significant **influence on the share or company value** (especially in the area of Fast Moving Consumer Goods, where calls for **boycotts** can be extremely harmful).

As can be seen from the latest reports in the press, a combination of profit distribution measures (or their mere announcement) with the use of state aid can be taken up in the media and meet with broad interest among the population. **Reputational aspects** may well become **value-forming factors**.

How should executive bodies, supervisory boards and shareholders behave in this area of conflict? Are they well-advised to make use of legally permissible possibilities, even if they may receive negative media coverage? Can and should management and supervisory board members attempt to influence the profit appropriation behavior of their shareholders? Can it be appropriate to take reputational aspects into account when making profit appropriation proposals and resolving on dividends?

Influence of the Pandemic on the distribution policy and interaction with KfW programmes

Executive Boards must also consider whether and to what extent a **dividend policy might conflict with the use of KfW programmes.**

May disbursements still be made today if an application for KfW funds is to be submitted promptly?

May a resolution on the appropriation of profits still be implemented if (massive) deterioration has occurred?

What information on legal transactions and/or disbursements made must be provided in the KfW applications without the risk of the loan agreement being terminated at a later date due to insufficient information - or even criminal sanctions?

How can executive bodies ensure that the necessary **liquidity raising under the KfW programmes is not undermined** by the general meeting or the shareholders' meeting approving profit distributions?

How can it be ensured, when the loan agreement is signed, that **distributions are not made contrary to the agreement?**

How to interpret the statements in the KfW information leaflets, according to which the prohibition of profit and dividend distributions is also to extend to profit and **dividend distribution resolutions already adopted by general meetings?** Do they prohibit the executive bodies from using KfW funds? Or do they allow them to draw on KfW funds and then refuse to implement the profit distribution resolutions with reference to the clauses contained in the loan agreements?



Criminal law relevance and implications

As is well known, **the correctness of the information to be provided in the context of applications for public funding** is also safeguarded by criminal sanctions. **False statements can result in criminal charges.**

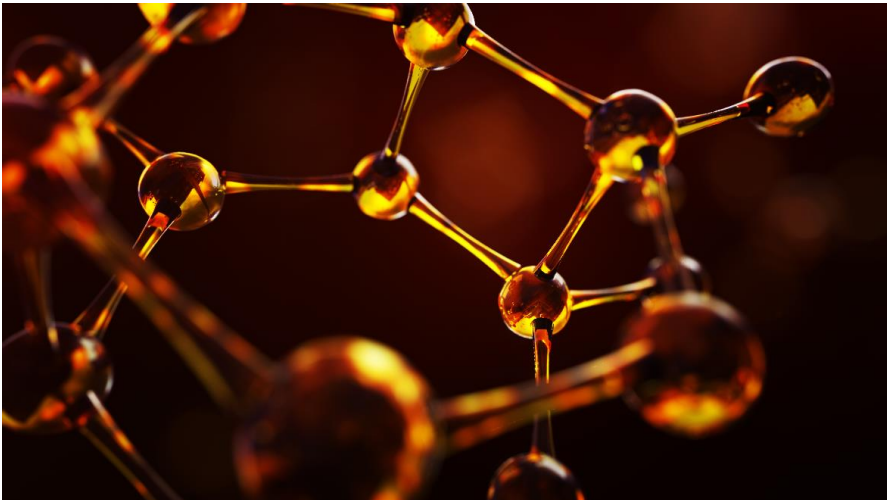
Depending on the respective constellation, the offence of **subsidy fraud**, Section 264 of the German Criminal Code (StGB), which does not require willful acts (*Vorsatz*), but can also be present in the case of **reckless conduct**, comes into consideration here.

In the case of false statements in the course of credit applications, a charge according to Section 265b StGB - **credit fraud** - is to be considered, in all other respects a charge according to Section 263 StGB - **fraud**, in the case of applications for deferral of taxes, potentially a charge according to **Sections 370, 378 AO**.

The **modified KfW provisions** may also be of considerable importance in this respect. The KfW conditions encompass **factors that can hardly or not at all be controlled by the executive officers** responsible for the application - especially when it comes to restrictions on dividend payments, etc.

What should an executive body do if distributions have been made shortly before KfW funds are drawn down? How should it act if it knows that the shareholders could decide on distributions?

Do board members expose themselves to the risk of criminal prosecution if the company makes use of KfW funds against this background? Or a risk of personal claims for breach of duty if it does not use KfW funds?



Dividend restrictions for certain sectors, especially FSI

It is not possible to go into more detail in the context of the present contribution with regard to **special distribution restrictions for certain sectors**, in particular **insurers and reinsurers as well as financial institutions**.

It should be noted, however, that the European Insurance and Occupational Pensions Authority (**EIOPA**), in a statement dated April 2, 2020, called on insurers and reinsurers to refrain from any discretionary dividend payments and share buybacks in view of the COVID 19-Pandemic-induced uncertainties in their assessment of the situation.

In response to this statement by EIOPA, **BaFin** has reaffirmed its expectation that financial institutions should refrain from share buybacks and carefully consider dividend payments, profits and bonuses. However, BaFin does not consider a blanket ban on distributions for insurance companies and pension funds to be advisable at present. At the same time, BaFin also points out that the dividend policy "must of course take into account the individual situation of the insurers," "especially their risk-bearing capacity". Any risks arising from the current crisis situation must be taken into account appropriately in any dividend payouts.

The **European Banking Authority (EBA)** had also reiterated its call to banks to refrain from paying dividends to shareholders for the time being and to refrain from share buybacks in a declaration dated 31 March 2020.



Guidance for action

Executive bodies and their members are well advised to **pay even greater attention to the approval of annual financial statements and the determination of the annual net profit** and, if necessary with the help of consultants, to carefully consider whether and, if so, in what way the effects of the COVID-19-Pandemie should be taken into account in the annual financial statements.

The same applies to any **proposals for the appropriation of profits** - here it may be advisable, in case of doubt, to provide for an allocation to reserves and to give reasons for this.

In the context of resolutions on the appropriation of profits, it must be carefully examined whether the shareholders, **are obliged by their fiduciary duty to refrain from making a full distribution** - even if this would be possible without violating capital maintenance rules. This applies in particular in group constellations, where there is a particular threat of a revival and/or more frequent application of the legal doctrine of unlawful interference (*Rechtsfigur des existenzvernichtenden Eingriffs*).

Special attention must also be paid to the **execution of resolutions already passed on the distribution and/or appropriation of dividends**. Here, not only the absolute limit of the capital maintenance rules must be observed, but also, the execution of such resolutions may have to be dispensed with in advance if it is foreseeable that the liquidity situation of the company has deteriorated and/or threatens to deteriorate considerably further.

At least where the corporate form and shareholder structure permit, the members of the executive bodies would be well advised to **openly discuss with the shareholders** the question of possible recourse to the KfW Special Programmes 2020 and their interaction with resolutions on the appropriation of profits and their execution - in this way liability risks can be significantly reduced, at least in relation to the company.



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