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Insolvency Law

Directors' obligations in the period approaching insolvency

Note by the Secretariat

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Introduction

1. At its forty-third session in 2010, the Commission had before it a series of proposals for future work on insolvency law (A/CN.9/WG.V/WP.93 and Add.1-6 and A/CN.9/582/Add.6). Those proposals had been discussed at the thirty-eighth session of Working Group V (see A/CN.9/691, paras. 99-107) and a recommendation on potential topics made to the Commission (A/CN.9/691, para. 104). An additional document (A/CN.9/709), submitted after that session of Working Group V, set forth material additional to the proposal of Switzerland contained in A/CN.9/WG.V/WP.93/Add.5.

2. After discussion, the Commission endorsed the recommendation by Working Group V contained in document A/CN.9/691, paragraph 104, that activity be initiated on two insolvency topics, both of which were of current importance, and where a greater degree of harmonization of national approaches would be beneficial in delivering certainty and predictability.

3. The subject of this note is the second topic, proposed by the United Kingdom (A/CN.9/WG.V/WP.93/Add.4), INSOL International (A/CN.9/WG.V/WP.93/Add.3) and the International Insolvency Institute (A/CN.9/582/Add.6), concerning the responsibility and liability of directors and officers of an enterprise in insolvency and pre-insolvency cases.[1] In the light of concerns raised during extensive discussion, the Commission agreed that the focus of the work on that topic should only be upon those responsibilities and liabilities that arose in the context of insolvency, and that it was not intended to cover areas of criminal liability or to deal with core areas of company law.

4. Discussion of this topic commenced at the Working Group's thirty-ninth session (December 2010, Vienna) and continued at its fortieth session (October-November 2011, Vienna). The deliberations and conclusions of the Working Group are set forth in the reports of those sessions (A/CN.9/715 and A/CN.9/738 respectively).

5. This note, in accordance with the decision of the Working Group at its fortieth session (A/CN.9/738, para. 38), adopts the form of the Legislative Guide on Insolvency Law, containing both a draft commentary on relevant issues and a set of draft recommendations. It has been prepared, in terms of style and cross-references to the commentary and recommendations of the Guide so that it could form a part of the Legislative Guide (part IV) should the Working Group decide that to be the most desirable form for this work to take. The material set forth below builds upon documents A/CN.9/WG.V/WP.96 and 100, as well as decisions taken by the Working Group at its thirty-ninth and fortieth sessions.

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[1] The first topic, concerning centre of main interests and related issues is discussed in A/CN.9/WG.V/WP.103 and Add.1.

I. Directors' obligations in the period approaching insolvency

A. Introduction

6. Corporate governance frameworks regulate a set of relationships between a company's management, its board, its shareholders and other stakeholders and provide not only the structure through which the objectives of the company are established and attained, but also the standards against which performance can be monitored. Good corporate governance should provide incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders, as well as fostering the confidence necessary for promoting business investment and development. Much has been done at the international level to develop widely adopted principles of corporate governance that include the obligations of directors when the company is solvent.[2]

7. Once insolvency proceedings commence, many insolvency laws recognize that the obligations of the directors will differ both in substance and focus from those applicable prior to the commencement of those proceedings, with the emphasis on prioritizing maximization of value and preservation of the estate for distribution to creditors. Often directors will be displaced from ongoing involvement in the company's affairs by an insolvency representative, although under some insolvency laws they may still have an ongoing role, particularly in reorganization. The obligations of the directors once insolvency proceedings commence are addressed above in recommendations 108-114 and in the commentary, part two, chapter III, paragraphs 22-34. Recommendation 110 specifies in some detail the obligations that should arise under the insolvency law on commencement of insolvency proceedings and continue throughout those proceedings, including obligations to cooperate with and assist the insolvency representative to perform its duties; to provide accurate, reliable and complete information relating to the financial position of the company and its business affairs; and to cooperate with and assist the insolvency representative in taking effective control of the estate and facilitating recovery of assets and business records. The imposition of sanctions where the debtor fails to comply with those duties is also addressed (recommendation 114 and paragraph 34 of the commentary). In some systems, directors may be criminally liable for failure to observe those duties, while in others they may be personally liable for any damage caused as a result of the breach of those duties.

8. Effective insolvency laws, in addition to providing a predictable legal process for addressing the financial difficulties of troubled debtors and the necessary framework for the efficient reorganization or orderly liquidation of those debtors, should also permit an examination to be made of the circumstances giving rise to insolvency and in particular the conduct of directors of an enterprise. However, little has been done internationally to harmonize the various approaches of national law that might facilitate examination of that conduct and significant divergences remain. Nevertheless, the role and responsibilities of directors of a company in the period leading up to an application for or commencement of insolvency proceedings are increasingly the subject of debate, particularly in view of widespread failures following the global financial crisis.

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[2] See for example the OECD Principles of Corporate Governance, 2004.

9. A business facing an actual or imminent inability to meet its obligations as they fall due needs robust management, as often there are difficult decisions and judgements to be made. Competent directors should understand the company's financial situation and possess all reasonably available information necessary to enable them to take appropriate steps to address financial distress and avoid further decline. At such times, they are faced with choosing the course of action that best serves the interests of the enterprise as a whole, having weighed the interests of the different stakeholders in the circumstances of the specific case. Directors afraid of the possible financial repercussions of making such decisions may prematurely close down a business rather than seek to trade out of difficulties or they may engage in inappropriate behaviour, including unfairly disposing of assets or property. However, the different interests and motivations of stakeholders are not so easily balanced and provide a potential source of conflict. For example, where directors are also shareholders of the enterprise, the incentive may be to maximize their own position by imprudently seeking to trade out of insolvency or to hold out on any potential sale in the hope of a better return, especially where the sale price would cover only creditor claims, leaving nothing for shareholders. Such courses of action may involve adopting high-risk strategies to save or increase value for shareholders, at the same time putting creditors' interests at risk. Those actions may also reflect limited concern for the chances of success because of the protection of limited liability or director liability insurance if the course of action adopted fails.

10. Despite the potential difficulties associated with taking appropriate business decisions, when a company faces financial difficulties it is essential that early action be taken. Financial decline typically occurs more rapidly than many parties would believe and as the financial position of an enterprise worsens, the options available for achieving a viable solution also rapidly diminish. That early action must be facilitated by ease of access to relevant procedures; there is little to be gained by urging early action by directors if that action cannot be directed towards relevant and effective procedures.[3] Moreover, those laws that expose directors to liability from trading during the conduct of informal procedures such as restructuring negotiations (discussed in part one, chap. II, paras. 2-18) may operate to deter early action. While there has been an appropriate refocusing of insolvency laws in many countries to increase the options for early action to facilitate rescue and reorganization of enterprises, there has been little focus on creating appropriate incentives for directors to use those options. Often, it is left to creditors to pursue those options or commence formal proceedings because the directors have failed to act on a timely basis.

11. A number of jurisdictions address the issue of encouraging early action by imposing an obligation on a debtor to apply for commencement of formal proceedings within a certain specified period of time after insolvency occurs in order to avoid trading whilst insolvent. Other laws address the issue by focusing on the obligations of directors in the period before the commencement of insolvency proceedings and imposing liability for the harm caused by continuing to trade when it was clear or should have been foreseen that insolvency could not be avoided. The rationale of such provisions is to create appropriate incentives for early action and

[3] It has been suggested that the dearth of cases under insolvent trading legislation in one State is because of the relative ease of access to voluntary procedures and only those companies that are hopelessly insolvent are ultimately liquidated.

use of restructuring negotiations or reorganization and stop directors from externalizing the costs of the company's financial difficulties and placing all the risks of further trading on creditors.

12. The imposition of such obligations has been the subject of continuing debate. Those who acknowledge that such an approach has advantages[4] point out that the obligations may operate to encourage directors to act prudently and take early steps to stop the company's decline with a view to protecting existing creditors from even greater losses and incoming creditors from becoming entangled in the company's financial difficulties. Put another way, they may also have the effect of controlling and disciplining management, dissuading them from embracing excessively risky courses of action or passively acquiescing to excessively risky actions proposed by other directors because of the sanctions attached to the failure to perform the obligations. An associated advantage may be that they provide an incentive to management to obtain competent professional advice when financial difficulties loom.

13. Those commentators who suggest that there are significant disadvantages cite the following examples. There is a possibility that directors seeking to avoid liability will prematurely close a viable business which otherwise could have survived, instead of attempting to trade out of the company's difficulties. Properly drafted provisions, however, would discourage overly hasty closure of businesses and encourage directors to continue trading where that is the most appropriate way of minimizing loss to creditors. It is also suggested that the obligations may be regarded as an erosion of the legal status brought by incorporation, although it can be argued that limited liability should be seen as a privilege and courts have been alive to the potential for abuse of limited liability where it is to the detriment of creditors. Such obligations might also be regarded as a weakening of enterprise incentives on the basis that too much risk may discourage directors. Properly drafted provisions would focus not so much on the causes of distress, but on the directors' acts or omissions subsequent to that point. Examples from jurisdictions with such obligations suggest that only the most clearly irresponsible directors are found liable.

14. It is also said that such obligations may increase unpredictability, because liability depends on the particular circumstances of each case and also on the future attitudes of the courts. It is suggested that many courts lack the experience to examine commercial behaviour after the event and second guess the decisions that directors took in the period in question. However, in jurisdictions with experience of enforcing such obligations, courts tend to defer to directors' actions, especially when those directors have acted on independent advice. A further suggestion is that there is an increased risk of unexpected liabilities for banks and others who might be deemed to be directors by reason of their involvement with the company, particularly at the time of the insolvency. It is desirable that relevant legislation provide due protection for such parties when they are acting in good faith, at arm's length to the debtor and in a commercially reasonable manner. It is also argued that imposing such obligations overcompensates creditors who are able to protect themselves through their contracts, making regulation superfluous. This approach presupposes, for example, that creditors have a contract with the debtor, that they

[4] E.g. Directors in the Twilight Zone III (2009), INSOL International, Overview, p. 5.

are able to negotiate appropriate protections to cover a wide range of contingencies and that they have the resources, and are willing and able, to monitor the affairs of the company. Not all creditors are in this position.

15. Director obligations and liabilities are specified in different laws in different States, including company law, civil law, criminal law and insolvency law and in some instances, they may be included in more than one of those laws or they may be split between those laws. In common law systems, the obligations may apply by virtue of common law, as well as pursuant to relevant legislation. Moreover, different views exist as to whether the obligations and liabilities of directors are properly the subject of insolvency law or company law. These views revolve around the status of the company as either solvent, which is typically covered by laws not dealing with insolvency such as company law, or subject to insolvency proceedings, which is addressed by insolvency law. A period before the commencement of insolvency proceedings, when a debtor may be technically insolvent, raises concerns that may not be adequately addressed by either company law or insolvency law. The imposition of obligations enforceable retroactively after commencement of insolvency proceedings may lead to an overlap between the duties applicable under different laws and it is desirable that, in order to ensure transparency and clarity and avoid potential conflicts, they be reconciled.

16. Not only do the laws in which the obligations are to be found vary, but the obligations themselves vary: those applicable before the commencement of insolvency proceedings typically differ from those applicable once those proceedings commence (see part two, chapter III, paras. 22-33). The standards to be observed by directors in performing their functions also tend to vary according to the nature and type of the business entity e.g. a public company as distinct from a limited, closely held or private company or family business, and with the jurisdiction in which the entity operates. For public companies, the obligations are typically much more rigorous and complex than for other types of company.

17. The application of laws addressing director obligations and liabilities are closely related to and interact with other legal rules and statutory provisions on corporate governance. In some jurisdictions, they form a key part of policy frameworks, such as those protecting depositors in financial institutions, facilitating revenue collection, addressing priorities for certain categories of creditors over others (such as employees), as well as relevant legal, business and cultural frameworks in the local context.

18. Effective regulation in this area should seek to balance the often competing goals and interests of different stakeholders: seeking to preserve the freedom of directors to discharge their obligations and exercise their judgement appropriately, encouraging responsible behaviour, discouraging excessive risk-taking, promoting entrepreneurial activity, and encouraging, at an early stage, the refinancing or reorganization of enterprises facing insolvency. Such regulation could enhance both creditors' confidence and their willingness to do business with companies, encourage the participation of more experienced managers, who otherwise may be reluctant due to the risks related to failure, promote good corporate governance, leading to a more predictable legal position for directors and limiting the risks that insolvency practitioners will litigate against them once insolvency proceedings commence. Inefficient, antiquated and inconsistent guidelines on the obligations of those responsible for management of an enterprise as it approaches insolvency have

the potential to undermine the benefits that an effective and efficient insolvency law is intended to produce.

19. The purpose of this [part] is to identify basic principles to be reflected in insolvency law concerning directors' obligations when the company faces actual or imminent insolvency. Those principles may serve as a reference point and can be used by policy makers as they examine and develop appropriate legal and regulatory frameworks. Whilst recognizing the desirability of achieving the goals of the insolvency law (outlined above in part one, chap. I, paras. 1-14 and recommendation 1) through early action and appropriate behaviour by directors, it is also acknowledged that there are threats and pitfalls to entrepreneurship that may result from overly draconian rules. This [part] does not deal with the obligations of directors that may apply under criminal law, company law or tort law, focussing only on those obligations that may be included in the insolvency law and are enforceable once insolvency proceedings commence.

B. Identifying the parties who owe the obligations

20. In most States, a number of different persons associated with a company have obligations with respect to management and oversight of the company's operations. They may be the owners of a company, formally appointed directors, officers or managers (who may serve as executive directors) of a company and non-appointed individuals and entities, including third parties acting as de facto[5] or "shadow" directors,[6] as well as persons to whom the powers or duties of a director may have been delegated by the directors. Although some laws may provide that an enterprise group member cannot be appointed as a director of another group member, nevertheless, a group member may be considered, under a broad definition of "director", to be a director of other group members. This would typically occur where a group member (or its directors) performs functions concerning the

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[5] A de facto director is generally considered to be a person who acts as a director, but is not formally appointed as such or there is a technical defect in their appointment. A person may be found to be a de facto director irrespective of the formal title assigned to them if they perform the relevant functions. It may include anyone who at some stage takes part in the formation, promotion or management of the company. In small family-owned companies, that might include family members, former directors, consultants and even senior employees. Typically, to be considered a de facto director would require more than simply involvement in the management of the company and may be determined by a combination of acts, such as the signing of cheques; signing of company correspondence as "director"; allowing customers, creditors, suppliers and employees to perceive a person as a director or "decision maker"; and making financial decisions about the company's future with the company's bankers and accountants.

[6] A shadow director may be a person, although not formally appointed as a director, in accordance with whose instructions the directors of a company are accustomed to act. Generally, shadow directors would not include professional advisors acting in that capacity. To be considered a shadow director may require the capacity to influence the whole or a majority of the board, to make financial and commercial decisions which bind the company and, in some cases, that the company have ceded to the shadow director some or all of its management authority. In an enterprise group context, one group member may be a shadow director of another group member. In considering the conduct that might qualify a person to be a shadow director, it may be necessary to take into account the frequency of the conduct and whether or not the influence was actually exercised.

management and oversight of other group members. The issue may be most relevant in the context of controlled and parent group members, where the parent interferes in a sustained and pervasive manner in the management of the controlled group member. However, a decision by a controlled group member to support the parent in circumstances where it was in the controlled group member's interests to do so and not the result of interference from the parent would not render the parent a director of the other group member.

21. A broad definition may also include special advisors and in some circumstances, banks and other lenders, when they are advising a company on how to address its financial difficulties. In some cases, that "advice" may amount to determining the exact course of action to be taken by the company and making the adoption of a particular course of action a condition of extending credit. Nevertheless, provided the directors of the company retain their discretion to refuse that course of action, even if in reality they may be regarded as having little option because it will result in liquidation, and provided the outside advisors are acting at arm's length, in good faith and in a commercially appropriate manner, it is desirable that such advisors not be considered as falling within the class of person subject to the obligations.

22. There is no universally accepted definition of what constitutes a "director". As a general guide, however, a person might be regarded as a director when they are charged with making, do in fact make or ought to make key decisions with respect to functions such as: determining corporate strategy, risk policy, annual budgets and business plans; monitoring corporate performance; overseeing major capital expenditure; monitoring corporate governance practices; selecting, appointing, and supporting the performance of the chief executive; ensuring the availability of adequate financial resources; addressing potential conflicts of interest; ensuring integrity of accounting and financial reporting systems; and accounting to the stakeholders for the organization's performance. For ease of reference, the general term "director" is used in this [part] to refer to such persons. The obligations discussed below would attach to any person who was a director at the time the business was facing actual or imminent insolvency, and may include directors who subsequently resign (see para. 40 below). It would not include a director appointed after the commencement of insolvency proceedings.

Note to the Working Group

23. The Working Group may wish to consider use of a more generic term such as "responsible person".

C. When the obligations arise: the period approaching insolvency

24. The focus of this [part] is upon the obligations that directors might have at some point before the commencement of insolvency proceedings. Although the obligations would arise before commencement of those proceedings, they would only be enforceable once those proceedings commenced and as a consequence of that commencement and would apply retroactively in much the same way as avoidance provisions (see discussion at part two, chap. II, paras 148-150, 152). The point at which the obligations arise is variously described as the "twilight zone", the

"zone of insolvency" or the "vicinity of insolvency". Although a potentially imprecise concept, it is intended to describe circumstances in which there is a deterioration of the company's financial stability which, if it remains unaddressed, is likely to lead to insolvency and the commencement of insolvency proceedings.

25. If directors were to have additional obligations in the vicinity of insolvency, there are various possibilities for determining the time at which they might arise. One possibility may be the point at which an application for commencement of insolvency proceedings is made, arguably the possibility that creates the most certainty. If, however, the insolvency law provides for automatic commencement of proceedings following an application or the gap between application and commencement is very short (see recommendation 18), this option will have little effect.

26. Other possibilities focus on the obligations arising when a company is factually or technically insolvent, which under some laws may occur well before an application for commencement of insolvency proceedings is made. Taking the general approach of the Legislative Guide, insolvency might be said to have occurred in fact when a company becomes unable to pay its debts as and when they fall due, or when a company's liabilities exceed the value of its assets (recommendation 15). A further possibility is when insolvency is imminent, i.e. where the company will generally be unable to pay its debts as they mature (recommendation 15 (a)). These tests are increasingly used in insolvency laws as commencement standards and in some States are used as the basis for imposing an obligation on directors to apply for commencement of insolvency proceedings within a specified period of time, usually rather short, after a company becomes insolvent. The rationale for imposing obligations on directors from the same point of time is to encourage them to act so as to avoid insolvency or to take steps to minimize its extent, including, where appropriate, by initiating formal insolvency proceedings.

27. A somewhat different approach examines the knowledge of a director at a point before commencement of insolvency proceedings when, for example, the director knew, or ought to have known, that the company was insolvent, was likely to become insolvent, that there was no reasonable prospect that the company could avoid having to commence insolvency proceedings or that the continuity of the business was threatened, but before an irreversible situation of financial distress was reached or insolvency became inevitable. One concern with that type of standard might be the difficulty of determining with certainty the exact point at which the requisite knowledge could be imputed. However, it could be argued that provided a company's accounts are accurate, the director should be able to deduce when the company is in difficulty and when it might be in danger of satisfying these insolvency tests or, alternatively, the director can be assumed to have known the information that would have been revealed had the company complied with its obligations to maintain proper books of account and to prepare annual accounts. Such a standard would require a wider consideration of circumstances and context, including, for example, examining the books of the company and its financial position in its entirety. It could involve looking at revenue flows and debts incurred and contingencies, including the ability to raise funds. Generally speaking, evidence of a temporary lack of liquidity would not be sufficient.

D. The nature of the obligations

28. While the underlying rationale for considering directors' obligations in the vicinity of insolvency may be similar in different jurisdictions, different approaches are taken to formulating those obligations and determining the standard to be met. In general, however, laws focus upon two aspects — imposing civil liability for causing insolvency or failing to take appropriate action in the vicinity of insolvency (which might include an obligation to commence insolvency proceedings) and avoiding actions taken by directors in the vicinity of insolvency.

(a) Obligation to commence insolvency proceedings

29. As noted in paragraph 26, some laws impose on directors an obligation to apply for commencement of insolvency proceedings, which would include reorganization or liquidation, within a specified period of time, usually fairly short such as three weeks, after the date on which the company became technically insolvent. Failure to do so may lead to personal liability, in full or in part, for any resulting losses incurred by the company and its creditors, and in some cases criminal liability, if the company continues to trade. This obligation is discussed in part two, chapter I, paras. 35-36. In those jurisdictions where it is necessary to prove that the directors' actions were fraudulent in order to pursue a breach of this obligation, the obligations have proven difficult to enforce. For that reason, some jurisdictions have replaced or supplemented the "fraudulent trading" tests with a "wrongful trading" test, which provides that directors may be liable if they continue trading beyond the point where they knew or should have known that the company would be unable to avoid insolvent liquidation and have not taken proper steps to protect the interests of creditors.

(b) Civil liability

30. Civil liability imposed on a director in the vicinity of insolvency is typically based on responsibility for causing insolvency or failing to take appropriate action to monitor the financial situation of the company, avoid or ameliorate financial difficulty, minimize potential losses to creditors and avoid insolvency. Liability may arise when directors enter into transactions with a purpose other than ameliorating financial difficulty and preserving the value of the company (such as high-risk transactions or transactions that dispose of assets from the company's estate resulting in a material increase in the exposure of the company without justification). It may also arise when the directors knew that insolvency could not be avoided or that the company could not meet its obligations as they fell due, but nonetheless continued to carry on business that involved, for example, obtaining goods and services on credit, without any prospect of payment and without disclosing the financial situation of the company to those creditors. Under some laws, it may arise when the directors fail to meet various obligations to report inability to make certain payments, such as tax and social security premiums, or to make a formal declaration of insolvency.

31. Except under those laws where directors are required to report or make formal declarations, directors generally might be expected in the circumstances outlined above to act reasonably and take adequate and appropriate steps to monitor the situation so as to remain informed and thus are able to act to minimize losses to the

company and to creditors, to avoid actions that would aggravate the situation, and to take any reasonable action to avoid the company sliding into insolvency.

32. Adequate and appropriate steps might include, depending on the factual situation, some or all of the following:

(a) Directors could ensure proper accounts are being maintained and that they are up to date. If not, they should ensure the situation is remedied;

(b) Directors could ensure that they obtain accurate, relevant and timely information, in particular by informing themselves independently (and not relying solely on management advice) of the financial situation of the company, the extent of creditor pressure and any court or recovery actions taken by creditors or disputes with creditors;

(c) Regular board meetings could be convened to monitor the situation, with comprehensive minutes being kept of commercial decisions (including dissent) and the reasons for them, including, when relevant, the reasons for permitting the company to continue trading and why it is considered there is a reasonable prospect of avoiding insolvent liquidation. The steps to be taken might involve continuing to trade, as there may be circumstances in which it will be appropriate to do so even after the conclusion has been formed that liquidation cannot be avoided because, for example, the company owns assets that will achieve a much higher value if sold on a going concern basis. When the continuation of trading requires further or new borrowing (when permitted under the insolvency law), the justification for obtaining it and thus incurring further liabilities should be recorded to ensure there is a paper trail justifying directors' actions if later required;

(d) Specialist advice or assistance, including specialist insolvency advice could be sought. While legal advice may be important for directors at this time, key questions relating to the financial position of the company are typically commercial rather than legal in nature. It is desirable that directors examine the company's financial position and assess the likely outcomes themselves, but also seek advice to ensure that any decisions taken could withstand objective and independent scrutiny;

(e) Early discussions with auditors could be held and, if necessary, an external audit prepared;

(f) Directors could consider the structure and functions of the business with a view to examining viability and reducing expenditure. The possibility of holding restructuring negotiations or commencing reorganization could be examined and a report prepared;

(g) Directors could ensure that they modify management practices to focus on a range of interested parties, which might include employees, creditors, suppliers, customers, governments, shareholders and the environment, in order to determine the appropriate action to take. In the period when insolvency becomes likely or hard to avoid, shifting the focus from maximizing value for shareholders to taking account of the interests of creditors provides an incentive for directors to minimize the harm to creditors, who will be the key stakeholders once insolvency proceedings commence, of excessively risky, reckless or grossly negligent conduct;

(h) Directors could ensure that the company does not take actions that would result in the loss of key employees or enter into transactions of the kind referred to in recommendation 87 that might later be avoided, such as transferring assets out of the company at an undervalue. Not all payments or transactions entered into at this time are necessarily suspect; payments to ensure the continuance of key supplies or services, for example, may not constitute a preference if the objective of the payment was the survival of the business. It is desirable that the reasons for making the payment be clearly recorded in case the transaction should later be questioned;

(i) A shareholders' meeting could be called, in the best interests of the company and without undue delay, if it appears from the balance sheet that a stipulated proportion of the share capital has eroded (generally applicable where the law includes capital maintenance requirements).

(c) Avoidance of transactions

33. Recommendation 87 deals with the avoidance of transactions at an undervalue, transactions conferring a preference and transactions intended to defeat, delay or hinder creditors (see part two, chapter II, paras. 170-185). That recommendation would apply to the avoidance of transactions entered into by the company in the vicinity of insolvency. In addition, certain actions of directors may be rendered unlawful once a company becomes insolvent under, for example, wrongful or fraudulent trading provisions, or as acts having worsened the economic situation of the company or having led to insolvency, such as entering into new borrowing or providing new guarantees without sufficient justification. In addition to avoidance of the transaction, under some laws a director may be found personally liable for permitting the company to enter into such transactions. Liability would typically apply only in relation to directors who agreed to the transaction; those who expressly dissented and whose dissent was duly noted are likely to avoid responsibility.

E. The standard to be met

34. Laws dealing with the obligations of directors in the vicinity of insolvency typically judge the behaviour of directors in that period against a variety of standards to determine whether or not they have failed to meet the obligations.

35. Under some laws, the question of when a director or officer knew, or ought to have known, that the company was insolvent or was likely to become insolvent is judged against the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company. More may be expected of a director of a large company with sophisticated accounting systems and procedures. If the director's skills and experience exceed those required for the job, the judgement may be made against the skills and experience actually possessed, instead of against those required for the job. In contrast, inadequate skill and experience for the job may not excuse a director and they could be judged against the skill and experience required for the job.

36. Another approach requires that there be reasonable grounds for suspecting the company was insolvent or would become insolvent at the time of incurring the debt leading to insolvency. Reasonable grounds for suspecting insolvency requires more than mere speculation and the director must have an actual apprehension that there

is insolvency. This is a lower threshold than expecting or knowing the company is insolvent. The standard is that of a director of ordinary competence who is capable of having a basic understanding of the company's financial status and the assessment is made on the basis of knowledge such a director could have had and not on information that might later become apparent. Empirical evidence from jurisdictions with such provisions suggests that when reviewing what occurred, often some time before the review occurs, courts have demonstrated a good deal of understanding of the position in which directors find themselves, carefully analysing the situation they confronted and demonstrating appreciation for the business issues encountered. Courts have been reluctant to second guess directors in their commercial dealings, indicating that it is not appropriate to assume that what in fact happened was always bound to happen or was necessarily apparent at the time.

37. A further approach focuses on mismanagement. This may require a causal link between the act of mismanagement and the debts arising from it or that the mismanagement is an important cause of the company's insolvency. This approach requires that a director be guilty of a fault in management when judged against the standards of a normally well-advised director. Examples of behaviour or actions that might give rise to liability include imprudence, incompetence, lack of attention, failure to act, engaging in transactions that were not at arm's length or of a commercial nature and improperly extending credit beyond the company's means, while the most common failures have involved directors permitting the company to trade while manifestly insolvent and to have embarked on projects beyond its financial capacity and which were not in its best interests. Other examples of mismanagement include where directors have failed to undertake sufficient research into the financial soundness of business partners or other important factors before entering into contracts; where directors fail to provide sufficient information to enable the supervisory board to exercise supervision over management; where directors neglect the proper financial administration of the company; where they also neglect to take preventative measures against clearly foreseeable risks; and where bad personnel management by the directors leads to unrest and strikes. A finding of mismanagement does not require that a director have actively engaged in the management of the company; passive acquiescence may be sufficient.

F. Enforcement of the directors' obligations on commencement of insolvency proceedings

1. Defences

38. Under some laws, where directors do have obligations in the vicinity of insolvency, they may nevertheless rely on certain defences, such as the business judgement rule, to show that they have behaved reasonably. The business judgement rule establishes a presumption that directors have, for example, acted in good faith and had a rational belief that they acted in the best interests of the company, that they have had no material personal interest, and that they have properly informed themselves. A slightly different approach gives directors the benefit of the doubt on the assumption that business risks are an unavoidable and incidental part of management. As noted above, courts are reluctant to second guess a director who has satisfied the duties of care and loyalty, or to make decisions with the benefit of

hindsight. It may also be the case that the business judgement rule provides a defence to some, but not all, of the duties specified under the law.

39. Under laws providing liability for wrongful trading, directors would need to show that they had taken appropriate steps to minimize any potential loss to the company's creditors once they had concluded that the company would have difficulty avoiding liquidation. Provided they can show that they took reasonable and objective business decisions based on accurate financial information and appropriate professional advice, they are likely to be able to rely on this defence even if those decisions turn out to have been commercially wrong.

40. The fact that a director has no knowledge of the company's affairs would generally not excuse failure to meet the obligations. Moreover, resignation in the vicinity of insolvency will not necessarily render a director immune from liability, as under some laws they may leave themselves open to the suggestion that the resignation was connected to the insolvency, that they had become aware or ought to have been aware of the impending insolvency and that they had failed to take reasonable steps to minimize losses to creditors and ameliorate the situation. Where a director has dissented to a decision that is subsequently being examined, that dissent typically would need to have been recorded in order for the director to rely on it. Where a director is at odds with fellow directors over the action to be taken, and despite taking reasonable steps to persuade them has failed to do so, it may be appropriate for the director to resign, provided his or her efforts and advice are recorded.

2. Remedies

41. Many laws provide different remedies and combinations of remedies for breach of a director's obligations, including those under both civil and criminal law. In terms of civil law, the remedies focus on the provision of compensation for breach of the obligation and the damage caused, although the manner of measuring quantum varies. A few laws also provide for disqualification of a director from acting as a director or taking part in the running and management of a company.

(a) Damages and compensation

42. Where directors are found liable for actions or omissions in the vicinity of insolvency, the extent of the liability varies. Under some laws, directors may be liable for loss or damage suffered by individual creditors and employees, as well as the company itself, where the loss is a direct result of their acts or omissions. They may also be liable for payments that result in a reduction of the insolvency estate or that have resulted in the diminution of the company's assets. Some laws permit the court to adjust the level of liability to match the nature and seriousness of the mismanagement or other act leading to liability. In some cases, the liability may attach to specific directors, while in others, the liability of members of the board may be joint and several. Some laws provide that a director can be found liable for the difference between the value of the company's assets at the time it should have ceased trading and the time it actually ceased trading. An alternative formulation is the difference between the position of creditors and the company after the breach and their position if the breach had not taken place. A slightly different approach may allow recovery from the directors of the difference between available assets and the sum necessary for the company to meet its debts.

43. Some laws that include an obligation to apply for commencement of insolvency proceedings or to hold a shareholder meeting where there is a loss of capital also include provision for award of damages.

44. Where directors are found liable, the amount recovered may be specified as being for the benefit of the insolvency estate. Some laws provide that where there is an all-enterprise mortgage, any damages recovered are for the benefit of unsecured creditors (as noted in para. 12). It may be argued in such cases that compensation should not go to secured creditors as the cause of action does not arise until the commencement of insolvency proceedings and thus cannot be subject to a security interest created by the company prior to that point. Moreover, what is being sought is not the recovery of assets of the company, in contrast to an avoidance proceeding, but rather a contribution from directors to satisfy the claims of all creditors.

45. In addition to the above remedies, debts or obligations due from the company to directors may be deferred or subordinated and directors may be required to account for any property acquired or appropriated from the company or for any benefit obtained in the breach of his or her duties.

(b) Disqualification

46. A consequence provided for under a few laws when insolvency proceedings commence is disqualification of a director from being a director or from taking part in the running and management of a company. Such measures are typically regarded as protective measures designed to remove such directors from a position where they can cause further harm by continuing to perform management and director functions in the same or a different company. Under one law, disqualifications of between two and 15 years may be ordered where the individual is found to be "unfit" to act as a director. Factors relevant to that determination include: breach of a fiduciary duty; misapplication of moneys; making misleading financial and non-financial statements; and failure to keep proper accounts and make returns. It may also include acts relevant to the company's insolvency, such as the person's responsibility for the company entering into transactions liable to avoidance on grounds similar to those in recommendation 87 or the company continuing to trade when the director knew or should have known that it was insolvent. The various factors are generally considered cumulatively in determining unfitness in a specific case. In jurisdictions providing for disqualification, those found to be unfit often, though not always, have displayed a lack of commercial probity, gross negligence or serious incompetence.

47. Disqualification may sit alongside other remedies and sanctions as described above, or may be brought independently where the overall conduct of the individual as a director merits such a sanction.

3. Parties who may bring an action

48. A number of laws limit the right to bring an action against a director by reference to the nature of the action, the person with the power to pursue it and the time at which it is brought. Similar considerations also apply to the exercise of avoidance powers, addressed under recommendation 87 (see part two, chap. II, paras. 192-195).

49. A number of laws provide that when insolvency proceedings have commenced, it is only the insolvency representative who, having reviewed a director's actions prior to insolvency, has the right to proceed against the director to seek, for example, to avoid a particular transaction or to recover compensation for the benefit of creditors in respect of any loss caused to the company. Wrongful trading laws, for example, may permit the insolvency representative to pursue directors for contributions to the insolvency estate where their behaviour has contributed to their company's insolvency or constitutes an act of mismanagement. Some laws also permit such action to be brought by the public prosecutor or the court acting on its own motion. Under some laws in some circumstances, such as where the insolvency representative takes no action, creditors may have a derivative right (see part two, chap. II, paras. 192-195).

50. Under those laws imposing an obligation to commence insolvency proceedings, the company and creditors may have a claim for damages. Where payments have been made by directors contrary to a moratorium that accompanies the obligation to commence insolvency proceedings, the company itself may have a claim for damages. The company may also have a claim under laws that impose an obligation to hold a shareholder meeting if there is a loss of capital.

4. Funding of proceedings

51. A potential difficulty arising in those cases that permit the insolvency representative to bring an action relates to payment of their costs in the event that the action against the director is unsuccessful. The lack of available funding is often cited as a key reason for the relative paucity of cases pursuing the breach of such obligations. As is often the case with avoidance proceedings, insolvency representatives may be unwilling to expend assets of the insolvency estate to pursue litigation unless there is a very good chance of success (see part two, chap. II, para. 196). Different approaches to funding such proceedings might be adopted. Funding might be made available from the insolvency estate where there are sufficient assets to do so; the right to commence such a proceeding, or the expected proceeds of the proceeding if successful, might be assigned for value to a third party, including creditors; or the costs of commencing such a proceeding might be charged against any possible recovery. In some instances, claims against directors might be settled, avoiding the need to find funding. It is desirable that such proceedings be readily available and that appropriate means of providing funding are developed. It may be appropriate to consider the court in which such proceedings could be commenced; this issue is discussed above in part two, chapter. I, para. 19.

Draft recommendations 1-11

Purpose of legislative provisions

The purpose of provisions addressing the acts or omissions of those responsible for the management of the company ("directors") when the business faces actual or imminent inability to meet its obligations as they fall due is:

(a) To ensure that insolvency laws protect the legitimate interests of creditors from being harmed by the improper acts or omissions of directors at that time;

(b) To provide proportionate remedies for improper acts or omissions of directors where those acts or omissions cause or increase the scale of the insolvency and consequent losses to creditors; and

(c) To do so in a way that minimizes the risk that such provisions will:

(i) Adversely affect successful business reorganization;

(ii) Discourage persons from holding positions as directors particularly in businesses in financial difficulty; or

(iii) Prevent directors from exercising reasonable business judgement or taking reasonable commercial risk.

Contents of legislative provisions

1. The insolvency law should specify that when insolvency proceedings commence and it is established that the interests of creditors of the company have been harmed by the improper acts or omissions of a director, that director may be liable to the company for their conduct.

Parties that owe the obligations

2. The insolvency law should specify who owes the obligations. It may include any person defined under national law as fulfilling the role of a director [see the explanation of who may qualify as a director in paras. 20-22 above].

When the obligations arise

3. The insolvency law should specify that the obligations in recommendation 4 arise at the point at which a director knew, or ought reasonably to have known, that insolvency was likely or unavoidable.

The obligations

4. The insolvency law should specify that from the point in time referred to in recommendation 3, a director should have the following obligations:

(a) To take reasonable steps to avoid insolvency or to minimize the extent of insolvency where insolvency is unavoidable;

(b) To have due regard to the interests of creditors;

(c) To ensure they are fully informed about the affairs of the company, including by seeking professional advice where appropriate; and

(d) To ensure that assets of the company are protected and not commit or permit the company to enter into transactions of the type referred to in recommendation 87.

Liability

5. The insolvency law should provide remedies where a director has failed to fulfil the obligations in recommendation 4 and that failure has, either directly or indirectly, caused the insolvency or increased the losses to creditors.

6. The insolvency law should provide that a director who has exercised the due care and attention expected of a competent director would not be liable for failure to fulfil the obligations in recommendation 4.

Remedies

7. The insolvency law should provide that the liability of a director for breach of the obligations in recommendation 4 should be proportionate and be limited to the extent to which the breach, either personally or collectively, has caused losses to arise or increase. The remedies may include:

(a) An appropriate contribution towards payment of the company's debts;

(b) Compensation for the loss caused by any transaction covered by recommendation 87 that the company has entered into;

(c) A limitation on the exercise of set-off with respect to any debts owed by the company to the director;

(d) Where the director is a creditor, a requirement that the whole or any part of any debt owed by the company to the director should rank in priority after all other debts owed by the company.

Conduct of proceedings against a director

8. The insolvency law should specify that the insolvency representative has the principal responsibility to commence proceedings against a director for breach of the obligations in recommendation 4. The insolvency law may also permit any creditor to commence such proceedings with the agreement of the insolvency representative and, where the insolvency representative does not agree, the creditor may seek leave of the court to commence such proceedings.

Funding of proceedings against a director

9. The insolvency law should specify that the costs of such proceedings against a director be paid as administrative expenses.

10. The insolvency law may provide alternative approaches to address the pursuit and funding of such proceedings.

Additional measures

11. The insolvency law may include measures additional to the remedies set forth in recommendation 7 to deter behaviour of the kind leading to liability of a director under recommendation 5. Such measures may include restricting a director's ability to act as a director for a specified period of time.

Note to the Working Group

52. In the event that this material constitutes part four of the Legislative Guide, these recommendation would be numbered 255-266. Recommendations 8-10 are based on recommendations 93-95 of the Legislative Guide and are included on the basis that they are also appropriate to the conduct of proceedings to pursue a director for breach of the obligations applicable in the vicinity of insolvency.