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Insolvency Law

Directors' obligations in the period approaching insolvency

Note by the Secretariat

Contents

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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 and forty-first sessions (October-November 2011, Vienna and 30 April-4 May 2012, New York). The deliberations and conclusions of the Working Group are set forth in the reports of those sessions (A/CN.9/715, A/CN.9/738 and A/CN.9/742, respectively).

5. In accordance with the working assumption adopted by the Working Group at its forty-first session (A/CN.9/742, para. 74) that the work will form part of the Legislative Guide on Insolvency Law, this note includes both draft commentary (part I, paragraphs 6-51) and recommendations 1-10, as well as some general remarks on directors' obligations in the context of enterprise groups (part II) and cross-border issues (part III). The material set forth below builds upon documents A/CN.9/WG.V/WP.96, 100 and 104, as well as decisions taken by the Working Group at its thirty-ninth, fortieth and forty-first sessions. Paragraphs of the draft commentary contained in document A/CN.9/WG.V/WP.104 that have not been revised or that do not include revised text are not included in this note and are indicated thus — "6. […]". For ease of reference, this note retains the paragraph numbers used in document A/CN.9/WG.V/WP.104. Where a new paragraph has been added, it takes the number of the immediately preceding paragraph with the addition

[1] The first topic, concerning centre of main interests and related issues is discussed in A/CN.9/WG.V/WP.107.

of an alpha character. The reader's understanding of the changes proposed in this document will be assisted by comparing it with document A/CN.9/WG.V/WP.104.

I. Directors' obligations in the period approaching insolvency

A. Introduction

6. […]

7. […]

8. At the end of the first sentence, add the words "in the period before insolvency proceedings commence." In the third sentence, delete the words commencing with "Nevertheless" and ending with "proceedings" and insert the following words "The nature and extent of the duties directors might have in that period when the business might be experiencing financial distress but is not yet insolvent are not well established, but they".

9. At the end of the first sentence add the words "that will be critical to the company's survival, with consequent benefits to its owners, creditors, customers, employees and others." In the third sentence, add the word "relevant" before the word "stakeholders". Insert new fourth and fifth sentences as follows: "Under some laws, those stakeholders will be the corporation itself and its shareholders. Under other laws, they may involve a broader community of interests that includes creditors." Revise the final sentence to read: "Directors afraid of the possible financial repercussions of making difficult decisions in those circumstances may prematurely close down a business rather than seek to trade out of the problems, they may engage in inappropriate behaviour, including unfairly disposing of assets or property or they may also be tempted to resign, often adding to the difficulties that the company is facing."

9A. Revise the first sentence to read: "The different interests and motivations of stakeholders are not so easy to balance and provide a potential source of conflict." In the second sentence, revise the first few lines to read: "For example, shareholders of the enterprise, who typically are unlikely to share in any distribution in insolvency proceedings, are interested in maximizing their own position by seeking to trade out of insolvency" and the closing words to read: "and leave nothing for shareholders."

10. In the fourth sentence, replace the words "from trading" with the words "for trading". In the last sentence, revise the closing words to read: "act in a timely manner."

11. In the last sentence, revise the middle section to read: "for early action through the use of restructuring negotiations or reorganization and to stop directors from externalizing".

12. In the third sentence, replace the fourth word "they" with the words "the obligations" and in the third and fourth sentences replace the word "management" with "directors".

13. Insert a new second sentence as follows: "A rule which presumes mismanagement based solely on the fact of financial distress often causes otherwise

knowledgeable and competent directors to leave, and the opportunity to reorganize the company and return it to profitability is missed." At the end of the fourth sentence, add the following words: "and is more likely to balance the rights and legitimate expectations of all stakeholders, distinguishing cases of bad conduct from those involving bad luck or the impact of exogenous factors."

14. In the second sentence, add the words "may be inclined to" before the words "second guess". In the third sentence, replace "courts tend to" with the words "courts have tended to". In the penultimate sentence, add the word "all" before the word "creditors".

15. In the second last sentence, add the word "currently" before the words "may not be addressed". At the beginning of the last sentence, add the word "However".

16. In the first sentence, add the words "as noted above," after the colon.

17. […]

18. In the first sentence, replace the words "seeking to preserve" with the word "preserving" and after the word "discouraging" add the words "wrongful conduct and". In the last sentence, add the word "unclear"," after the word "Inefficient" and at the end of the sentence add the following words "and exacerbate the financial difficulty they are intended to address."

19. In the last sentence, replace the words "are enforceable" with the words "become enforceable".

B. Identifying the parties who owe the obligations

20. […]

21. […]

22. In the second sentence, place square brackets around the words "or" and "or ought to make".

23. [deleted]

C. When the obligations arise: the period approaching insolvency

24. Combine the first two sentences to read: The focus of this [part] is upon the obligations that might arise at some point before the commencement of insolvency proceedings and become enforceable once those proceedings commence and as a consequence of that commencement, applying retroactively in much the same way as avoidance provisions (see discussion at part two, chap. II, paras 148-150, 152). Revise the sentence commencing with the word "Although" to read: "Although a potentially imprecise concept, it is intended to describe a period in which there is a deterioration of the company's financial stability to the extent that, if it remains unaddressed and no remedial action is taken, insolvency becomes imminent (i.e. where the company will generally be unable to pay its debts as they mature (recommendation 15 (a) of the Legislative Guide) or unavoidable." Add a further two sentences as follows: "Determining exactly when these obligations arise is a critical issue for directors seeking to make decisions in a timely manner consistent

with those obligations. Moreover, without a clear reference point, it would be difficult for directors to predict with confidence what point in time in the period before insolvency proceedings commence a court would have reference to in considering an action for breach of those obligations."

25. Revise the first sentence to read: "There are various possibilities for determining the time at which directors' obligations might arise in the period before commencement of insolvency proceedings." In the second sentence, replace the word "creates" with the word "provides". At the end of the paragraph, add the words "in terms of encouraging directors to take early action."

26. In the fourth sentence, replace the words "are used as" with the word "form". Revise the final sentence to read: "The rationale for imposing obligations on directors based on these tests of solvency is to encourage them to act so as to avoid insolvency or, where it is it unavoidable, to take steps to minimize its extent, including, where appropriate, by initiating formal insolvency proceedings."

27. Insert a new fourth sentence as follows: "Essentially, the standard requires a director's judgement to be assessed against the knowledge that a reasonable director should or ought to have had in the circumstances."

D. The nature of the obligations

28. At the end of the paragraph, revise the words after the parentheses to read: "and the avoidance in insolvency proceedings of actions taken by directors, including transactions entered into, in the vicinity of insolvency."

(a) Obligation to commence insolvency proceedings

29. […]

(b) Civil liability

30. […]

31. After the words "minimize losses to the company" add the words "(including to its shareholders)".

32. […]

(a) […]

(b) Add the following sentence at the end of the subparagraph: "Directors may need to devote more time and attention to the company's affairs at such a time than is required when the corporation is healthy."

(c)-(f) […]

(g) Revise the reference to "the environment" to "as well as environmental concerns". At the end of the subparagraph, before the words "of excessively", add the words "that might be the result";

(h) In the first sentence after the words "Directors could ensure that the" add the words "assets of the company are protected and that the". Insert a new second sentence as follows: "In certain circumstances, not all assets will require

protection, for example, those that are worth less than the amount for which they are secured, are burdensome, of no value or hard to realize (see part two, chap. II, para. 88).” At the end of the paragraph, insert the following sentence: “Directors with substantial stockholdings or who represent major shareholders may not be considered disinterested or objective and might need to take especial care when voting on transactions in the vicinity of insolvency;”.

(i) […]

Joint and several liability

32A. Typically, liability for breach of their obligations attaches to directors jointly and severally, although under some laws the court may have the discretion to order one of a number of directors to bear the whole burden of liability or one director to contribute more when, for example, it is found that culpability for the damage caused is not equal. Joint and several liability as the starting point may enhance the deterrent factor of imposing such obligations since directors will have an incentive to monitor the conduct of their fellow directors so as to avoid liability for their conduct.

32B. Directors may take steps to avoid or reduce their liability for decisions that are subsequently called into question. This may require them to comply with certain formal requirements, such as entering a dissent in the minutes of the meeting; delivering a written dissent to the secretary of the meeting before its adjournment; or delivering or sending a written dissent promptly after the adjournment of the meeting to the registered office of the corporation. Directors who are absent from a meeting at which such decisions were taken may be deemed to have consented unless they follow applicable procedures, such as taking steps to record their dissent within certain specified periods of time after becoming aware of the relevant decision.

32C. Liability may be minimized through insurance or the use of indemnities. Once a claim has been made against a director, it may be possible under some laws to reach a settlement through negotiation with the insolvency representative; in some jurisdictions that is the usual approach.

(c) Avoidance of transactions

33. In the second sentence, insert the words “some laws render” after the words “In addition” and delete the words “may be rendered” after the word “directors”. In the fourth sentence after the word “Liability” insert the words “under those provisions”.

E. The standard to be met

34. Delete the word “typically”.

35. […]

36. In the first sentence, insert the words “or entering into the transaction” after the word “debt”. In the second sentence, replace the words “that there is

insolvency" with the words "that the company is insolvent." In the fourth sentence, replace the word "occurs" with the words "takes place".

37. In the third sentence commencing "Examples of behaviour", add the words "under those laws" after the word "liability". At the beginning of the final sentence, add the words "Under some laws that adopt this approach, a".

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

1. Defences

38. In the last line, replace the word "duties" with the word "obligations".

39. In the second sentence, add the words "as a" before the word "defence".

40. […]

2. Remedies

41. At the beginning of the first sentence, delete the words "Many laws provide" and revise the words after "director's obligations" to read: "are provided under". Add a new penultimate sentence as follows: "Typically, there is no punitive damages element."

(a) Damages and compensation

42. Revise the third sentence to read: "In general, as noted above, the liability of members of a board is likely to be joint and several, but in some cases it may attach to specific directors."

43. Revise the last words to read: "also make provision for the award of damages."

44. Revise the first two sentences to read: "Where directors are found liable, the amount recovered may be specified as being for the benefit of the insolvency estate, on the basis that the principal justification for pursuing directors is to recover some of the value lost as a result of the directors' actions in the form of compensation for the estate. It is thus for the benefit of all, rather than individual, creditors." In the second sentence, replace the words "there is" with the words "the company has". In the third sentence, replace the words "such cases" with the words "support of that approach". At the end of the paragraph, add the following sentence: "Where, however, the insolvency law permits creditors to pursue directors (see below), there may be grounds for suggesting that compensation be applied, in the first instance, to cover the costs of the creditor or creditors commencing the proceeding and to satisfy their claims or to modify the priority of their claims."[2]

45. Revise the last word to read: "breach of the obligations."

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[2] **Note to the Working Group**. The Working Group may wish to consider whether the commentary should address the question of whether or not the director has the capacity to pay any compensation ordered and the consequences of a lack of that capacity.

(b) Disqualification

46. […]

47. […]

3. Parties who may bring an action

48. At the end of the first sentence, add the words "i.e. before or after the commencement of insolvency proceedings." Revise the second sentence to read: "Considerations similar to those applicable to the exercise of avoidance powers, addressed under recommendation 87 (see part two, chap. II, paras. 192-195) may apply."

49. In the first sentence, after the words "against the director", delete the words commencing with "to seek" and ending with "transaction or".

49A. Although a major justification for imposing obligations on directors in the vicinity of insolvency is the protection of creditor interests, not all laws permit creditors to pursue a director for breach of those obligations. Under some laws in some circumstances, such as where the insolvency representative takes no action, creditors, and sometimes shareholders, may have a derivative right to bring an action (see part two, chap. II, paras. 192-195). Under other laws, a single creditor can only pursue directors with the consent of the majority of creditors or the creditor committee or creditors can request the creditors' representative or committee or the court to undertake any such action, as creditors have no independent right to pursue a claim.

49B. Where it is deemed appropriate for the law to permit creditors to pursue directors, a distinction might be drawn between creditors whose debt arose in the period approaching insolvency as a direct result of the conduct being examined and creditors whose debt predated that period. The former might have, in addition to a right to commence proceedings for the benefit of the insolvency estate, a personal right to claim damages against the director on the basis that the conduct being examined occurred in the twilight period and exacerbated the financial difficulties of the debtor. Under some laws, that individual right is limited to situations where the egregious behaviour in question has been directed at a particular creditor. Should it be regarded as desirable to permit creditors to pursue a director, the insolvency law as it applies to avoidance proceedings might provide a useful example of the procedure to be followed (see part two, paras. 192-195). The law might require, for example, the prior consent of the insolvency representative to ensure that they are informed as to what creditors propose and have the opportunity to refuse permission, thus avoiding any negative impact those proceedings may have on administration of the estate.

[49C. Where the consent of the insolvency representative or creditors is required, but not obtained or refused, the insolvency law might permit a creditor to seek court approval to pursue a director. The insolvency representative should have a right to be heard in any resulting court hearing to explain why it believes the proceedings should not go ahead. At such a hearing, the court might give leave for the proceeding to be commenced or may decide to hear the case on its own merits. Such an approach may work to reduce the likelihood of any deal making between the various parties. Where creditor-initiated actions are permitted with respect to

avoidance, some laws require creditors to pay the costs of those proceedings or allow sanctions to be imposed on creditors to discourage potential abuse of those proceedings; the same approach might be adopted with respect to actions brought by creditors against directors.][3]

50. Revise the first sentence to read: "Under those laws imposing an obligation on directors to commence insolvency proceedings (see para. 29), the company itself, its shareholders and creditors may have a claim for damages in the event of a breach of that obligation." At the end of the paragraph, add the following sentence: "It is desirable that the insolvency law ensure coordination of any proceedings that might potentially be commenced by these different parties."

4. Funding of proceedings

51. Revise the paragraph to read as follows: "A potential difficulty arising in those jurisdictions that permit insolvency representatives to bring an action relates to payment of their costs in the event that an action brought against the directors 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. While funding might be made available from the insolvency estate where there are sufficient assets to do so, as is often the case with avoidance proceedings, insolvency representatives may be unwilling to expend those assets to pursue litigation unless there is a very good chance of success (see part two, chap. II, para. 196). In many cases, however, there will be insufficient funds available in the insolvency estate to pursue a director, even if there is a strong likelihood that the litigation will be successful. Devising alternative approaches to funding in such circumstances may offer, in appropriate situations, an effective means of restoring to the estate value lost through the actions of directors, addressing abuse, investigating unfair conduct and furthering good governance. 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 a lender might be approached to provide funds. Where the cause of action is pursued by a party other than the insolvency representative, the costs of commencing such a proceeding might be recovered from any compensation paid. Under some laws, claims against directors might be settled through negotiation with insolvency representatives, avoiding the need to find funding. In some jurisdictions this occurs infrequently, while in others it is usual practice and insolvency representatives typically "invite" contributions from directors. As an additional issue, 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, paragraph 19."

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[3] **Note to the Working Group**. This paragraph is based upon material included in the Legislative Guide with respect to avoidance proceedings (specifically part two, chap. II, para. 193). The Working Group may wish to consider whether this paragraph should be included here or whether a cross-reference to the relevant paragraphs of the Legislative Guide would suffice.

Draft recommendations 1-10

Purpose of legislative provisions

The purpose of provisions addressing the obligations of [those charged with making decisions concerning the management of a company] [directors] that arise when insolvency is likely [imminent] or unavoidable is:

(a) To protect the legitimate interests of creditors and other stakeholders;

(b) To ensure [those charged with making decisions concerning the management of a company] [directors] are informed of their roles and responsibilities in those circumstances;

(c) To provide appropriate remedies for breach of those obligations, which may be enforced after insolvency proceedings have commenced.

Paragraphs (a)-(c) should be implemented in a way that does not:

(a) Adversely affect successful business reorganization;

(b) Discourage participation in the management of companies, particularly those experiencing financial difficulties;

(c) Prevent the exercise of reasonable business judgement or the taking of reasonable commercial risk.

Remarks

1. Paragraph (b) has been added to the purpose clause in accordance with the Working Group's decision at its forty-first session (A/CN.9/742, para. 99) to include the purpose of serving as a tool to educate directors on their roles and responsibilities in the period approaching insolvency. The second part of new paragraph (c) has been added to clarify that the obligations only become enforceable once insolvency proceedings commence. What was formerly paragraph (c) is now included as a second sentence.

Contents of legislative provisions

Recommendation 1 [previously recs. 4, 6]

The obligation

1(1) The [insolvency law] [law relating to insolvency] should specify that from the point in time referred to in recommendation 2, the persons specified in recommendation 3 will have an obligation to have due regard to the interests of creditors and other stakeholders and:

(a) Take reasonable steps to avoid insolvency

(b) Where insolvency is unavoidable, to minimize the extent of insolvency.

(2) Reasonable steps might include: ensuring [they are] [he or she is] fully informed about the affairs of the company; seeking professional advice where appropriate; [and] ensuring the assets of the company are protected; [and not committing or permitting the company to enter into the types of transaction that might be subject to avoidance in accordance with [part two, chapter two] [recommendation 87].

Remarks

2. The sequence of the draft recommendations has been revised to focus firstly on the obligation and then upon when it arises and who owes it. However, one consequential drafting issue the Working Group may wish to consider concerns the use of the term "director" in the purpose clause and recommendations 1 and 2. Since the party owing the obligation is the subject of a substantive recommendation (rec. 3), it may be appropriate to refer in other recommendations to the person specified in recommendation 3 or to refer to the person in a more generic manner, such as the person charged with making decisions concerning or responsible for the management of the company.

3. At its forty-first session, the Working Group requested the Secretariat to reconsider recommendations 1, 4, 5 and 6 (A/CN.9/742, para. 93). The current draft of recommendation 1 combines the previous drafts of recommendations 4 and 6. Paragraph 1 addresses the elements of the obligation, while paragraph 2 expands upon what might constitute the reasonable steps required to be taken under paragraph 1.

4. The reference to the insolvency law (or the law relating to insolvency) is intended to indicate that the obligation in recommendation 1 applies only under that law and that although the breach of the obligation must occur before the commencement of insolvency proceedings in accordance with recommendation 2, liability can only arise once those proceedings commence. If this is not sufficiently clear, it may be desirable to repeat the second part of purpose clause (c) in the body of the recommendations.

5. The second arm of the obligation in recommendation 1 requires reasonable steps to be taken to avoid insolvency or to minimize the extent of insolvency where insolvency is unavoidable. This suggests that the obligation could arise at two potentially different points in time. In practice, however, the distinction between the two points in time may depend on the sequence of events and may only be seen with clarity after the event. For example, a catastrophic event or exogenous shock may lead to insolvency becoming unavoidable, without passing through any period in which corrective action could be taken. Alternatively, insolvency may become likely due to external factors such as a particular event or momentary downturn in the market, but not eventuate because of an improvement in those external factors or because of steps taken to avoid the consequences.

6. The Working Group may wish to consider whether the question of timing raises an issue that needs to be addressed in the drafting of the recommendations (particularly recommendations 1 and 2), or whether the current formulation is sufficiently clear.

Recommendation 2 [previously rec. 3]

The time at which the obligation arises

2. The [insolvency law] [the law relating to insolvency] should specify that the obligation in recommendation 1 arises at the point in time when the person specified in recommendation 3 knew, or ought reasonably to have known, that insolvency was likely [imminent] or unavoidable.

Remarks

7. At the forty-first session, it was agreed that recommendation 3 be retained as drafted (A/CN.9/142, para. 82). Some concern has been expressed, however, as to whether the current formulation covers both the financial situation of the debtor as a matter of fact (i.e. that insolvency was in fact "likely [imminent] or unavoidable" at the point of time in question) and the director's knowledge of that fact. As currently drafted, that issue should be covered by the words "was likely [imminent] or unavoidable" at the end of the draft recommendation, since knowledge can only be imputed as to a fact or situation that has occurred. However, the Working Group may wish to consider whether further words are required by way of clarification.

8. The Working Group may also wish to consider whether the question raised in paragraph 5 as to timing above needs to be addressed in recommendation 2 or whether the current formulation is sufficiently flexible to cover the various possibilities.

Recommendation 3 [previously rec. 2]

Persons that owe the obligation

3. The [insolvency law] [the law relating to insolvency] should specify [the person] who owes the obligation, which may include any person defined under national law as fulfilling the role of a director* [, such as a formally appointed director and any other person [exercising factual control] [[and performing the functions] [undertaking the responsibilities] of a director]].

* See the explanation of who may qualify as a director in paragraphs 20-22 above.

Remarks

9. At the forty-first session, various proposals were made with respect to this recommendation (A/CN.9/742, paras. 79-80). There is broad agreement that it should apply to persons defined under national law as fulfilling the role of a director. By way of example, it was proposed (para. 79) that the recommendation should apply to persons freely exercising management functions or making managerial decisions, including those who ought to be making such decisions, but do not necessarily do so. In order to provide more detail as to the types of person that should be included within that definition, the words in square brackets and a footnote referring to the relevant paragraphs of the commentary have been added.

Recommendation 4 [previously recs. 1, 5, 7]

Liability

4(1) The [insolvency law] [the law relating to insolvency] should specify that where [creditors' interests have been harmed] [creditors have suffered loss or damage] as a consequence of the breach of the obligation in recommendation 1 [committed in the period referred to in recommendation 2], the [person owing the obligation] [director] may be liable.

4(2) The [insolvency law] [law relating to insolvency] should provide that the liability for breach of the obligation in recommendation 1 is limited to the extent to which the breach caused loss or damage.

Remarks

10. Draft recommendation 4 combines ideas previously reflected in draft recommendations 1, 5 and the chapeau of recommendation 7, namely, that where the obligation in recommendation 1 is breached and creditors suffer loss or damage or their interests are harmed, the person to whom the obligation attaches may be liable. The remainder of the previous draft of recommendation 7 (i.e. paragraphs (a)-(d)) is now incorporated into draft recommendation 6. Paragraph (2) of draft recommendation 4 addresses a requirement previously included in the chapeau of draft recommendation 7 that the liability be proportionate to the damage caused or, in other words, that the liability is limited to the extent that the breach causes damage.

11. At the forty-first session, it was suggested (A/CN.9/742, paras. 77) that the words "committed in the period before the commencement of insolvency proceedings" should be added to what was previously recommendation 1 to clarify that the breach of the obligation must take place in the period before insolvency proceedings commence. Since draft recommendation 1 refers to recommendation 2, it may be desirable to retain only the cross-reference to draft recommendation 1 and avoid the added complexity of repeating the condition as to the time of the breach in draft recommendation 4.

Recommendation 5 [new, replaces rec. 6]

Elements of liability and defences

5. The [insolvency law] [law relating to insolvency] should specify the elements to be proved in order to establish a breach of the obligation in recommendation 1 and that, as a consequence, [creditors have suffered loss or damage] [creditors' interests have been harmed]; the party responsible for proving those elements; and specific defences to an allegation of breach of the obligation. Those defences may include that the [person owing the obligation] [director] took reasonable steps of the kind referred to in recommendation 1(2). The law may also establish presumptions and permit shifts in the burden of proof to facilitate the conduct of proceedings for breach of the obligation.

Remarks

12. At the forty-first session, concerns were expressed with respect to the manner in which draft recommendation 6 approached the question of proving a breach of the obligation in recommendation 1 and possible defences.

13. The draft recommendation now approaches the conduct of proceedings for failure to satisfy the obligations in recommendation 1 in the same manner that recommendation 97 of the Legislative Guide approaches the conduct of proceedings with respect to avoidance. That is, whilst pointing out the need for the law to address issues such as defences, elements to be proved, use of presumptions and burdens of proof, the draft recommendation leaves it to national law to determine and specify the exact requirements.

Recommendation 6 [previously rec. 7]

Remedies

6. The [insolvency law] [law relating to insolvency] should specify that the remedies for liability [may] [should] include payment in full to the insolvency estate of any damages assessed for breach of the obligation in recommendation 1. Failure to pay such damages in full should preclude the [person owing the obligation] [director] from exercising any right or claim against the insolvency estate [during the period in which the payment remains outstanding] [until payment in full is made].

Remarks

14. At its forty-first session, the Working Group decided that the draft recommendation should focus on the damage caused by the breach of the obligation in recommendation 1 and the provision of compensation for that damage. The revised recommendation makes it clear that damages accrue to the insolvency estate (draft recommendation 7 makes it clear that the ability or right to pursue a director is an asset of the insolvency estate). The second sentence is based upon paragraphs (c) and (d) of the previous draft of recommendation 7.

15. The requirement for payment in full before a director can claim against the estate is intended to resolve the question of whether set-off would be permissible. However, under some laws, a rule preventing the person owing the obligation from exercising any right or claim against the insolvency estate could create difficulties, since such a provision is closely linked with matters of property. It could be seen, for example, as cancelling creditors' property rights in claims. The intention of draft recommendation 6 is to encourage payment to be made and to prevent a director found liable for damages from benefitting from any distribution with respect to his or her claims against the estate while payment of the damages remains outstanding. The recommendation might clarify that what is intended is a postponement of the right to claim or exercise rights against the estate so long as payment in full is not made, not a cancellation of that right. See the footnote to paragraph 44 above concerning a director's ability to pay any damages assessed.

Recommendation 7 [previously rec. 8]

Conduct of proceedings for breach of the obligation

7. The [insolvency law] [the law relating to insolvency] should specify that the cause of action for [harm caused by] [loss or damage suffered as a result of the] breach of the obligation in recommendation 1 belongs to the insolvency estate and the insolvency representative has the principal responsibility to commence proceedings for breach of that obligation. The [insolvency law][law relating to insolvency] may also permit a creditor or any other party in interest to commence such proceedings with the agreement of the insolvency representative and, where the insolvency representative does not agree, the creditor or other party in interest may seek leave of the court to commence such proceedings.

Remarks

16. Draft recommendation 7 has been revised in accordance with the Working Group's decision at its forty-first session (A/CN.9/742, para. 96) that it should provide for creditors or other parties in interest to commence proceedings for breach of the obligation in recommendation 1. Since the term "party in interest" is defined in the glossary of the Legislative Guide (introduction, para. 12 (dd)), it is used in the revised recommendation to ensure shareholders and other relevant parties are included.

17. Since different jurisdictions may allow creditors and others to file causes of actions, that possibility might be included in the recommendation as an option. That right to commence such an action should belong to or be a part of the insolvency estate to provide a clear principle and a clear destination for the payment of any damages assessed with respect to the breach (see draft recommendation 6).

18. Under some laws, the majority of creditors or the creditors' committee must renounce the claim to pursue a director for breach before it can be assigned to an individual creditor. While that possibility is noted in the commentary (paras. 49A-B), it would add a further layer of complexity to the draft recommendation to provide (a) that the cause of action belongs to the estate, (b) that the insolvency representative has the right to pursue it, (c) that creditors might pursue it with the approval of the insolvency representative (or the court), and (d) that an individual creditor might only do so where approved by the majority of creditors in addition to the insolvency representative.

Recommendations 8 and 9 [previously recs. 9 and 10]

Funding of proceedings for breach of the obligation

8. The [insolvency law] [the law relating to insolvency] should specify that the costs of proceedings against a director be paid as administrative expenses.

9. The [insolvency law] [the law relating to insolvency] may provide alternative approaches to address the pursuit and funding of such proceedings.

Remarks

19. The substance of what were previously draft recommendations 9 and 10 was adopted by the Working Group at its forty-first session (A/CN.9/742, para. 97).

Recommendation 10 [previously rec. 11]

Additional measures

10. The [insolvency law] [the law relating to insolvency] may include measures additional to the remedies set forth in recommendation 6 to deter behaviour of the kind leading to liability under recommendation 4. [Such measures may include restricting [the ability of the person owing the obligation] [a director's ability] to act as a director for a specified period of time.]

Remarks

20. At the forty-first session, concerns were expressed with respect to the second sentence of the draft recommendation on the basis that it might amount to a

punitive measure and was therefore inappropriate (A/CN.9/742, para. 98). Since no agreement was ultimately reached on that point, it was agreed the second sentence should be retained in square brackets, pending further consideration.

II. Issues relating to directors of enterprise group members

A. General remarks

52. Part three of the Legislative Guide notes that enterprise groups are often characterized by varying degrees (from highly centralized to relatively independent) and types (vertical and horizontal) of integration and complex relationships between group members that may involve different levels of ownership and control. These factors, together with the manner in which such groups tend to be regulated under applicable law (i.e. as separate entities as opposed to a single enterprise), raise a number of issues for directors of group members. The following discussion considers two issues in the context of director's obligations in a group context. The first concerns the prevalence of the single entity principle and its impact on directors when there is a tension between acting in the interests of the group member of which they are a director and the interests of the group as a whole. The second concerns the definition of who may be considered a director (see paras. 20-22 above) and the circumstances in which other group members might fall within that definition, particularly where parent and wholly-owned or controlled subsidiary relationships are involved.

(a) The impact of enterprise group structures on director obligations

53. Typically, directors have obligations to their company and must act for the benefit or in the interests of that company. In the group context, the separate entity principle is to be respected and, under most laws, those same obligations apply, irrespective of any consideration of the interests of the group and the position of the director's company in the group structure. This focus on the individual group member's interests is of particular importance when the solvency of that group member may be or becomes an issue after any transaction designed to benefit the group as a whole has been entered into. As a practical reality, however, the group structure may involve directors having to act for the overall group's benefit, requiring them to balance the interests of their own group member against the possibly competing economic goals or needs of the group collectively. Examples of where this potential conflict could arise include where one group member is providing a loan to another group member or acting as a guarantor for a loan provided by an external lender to another group member; where one group member enters into an agreement with another group member to transfer its business or assets or surrender a business opportunity to that other group member or to contract with that member on terms that could not be considered commercially viable; or where a group member enters into cross-guarantees with other group members to assist the group as a whole to use its assets more effectively in financing group operations. These transactions may be problematic because of the relationship between the transacting parties (i.e. with respect to ownership and control) or their position within the group (i.e. parent or subsidiary) and because the nature of the transaction involves an allocation of benefit and detriment that differs from what

might generally be considered commercially viable. It may be easier, for example, to identify the benefits accruing to a parent from lending to or entering into other transactions with a wholly-owned subsidiary (downstream transactions) than the reverse (upstream transactions), especially where the subsidiary is not wholly-owned, or the benefits accruing from intra-group transactions between subsidiaries (lateral transactions).

54. While it may seem commercially unrealistic to require directors of group members to ignore the organizational structure within which their group member operates, the difficulty that arises with the considerations noted above is how to assess the benefit to be derived by the individual group member from a transaction that appears only sensible when viewed from the overall group perspective. In some cases, the benefit might be direct and relatively easy to ascertain; in others it may not be immediately apparent and may even require some sacrifice, even if only in the short term, for individual members. Moreover, that assessment might involve multiple factors similar to those outlined in recommendation 217 (part three), such as the relationship between the parties to the transaction and the degree of integration between them, the purpose of the transaction, whether the transaction granted advantages to group members or other related persons that would not normally be granted between unrelated parties and whether the transaction can be characterised as upstream, downstream or lateral.

55. Courts in different jurisdictions have accorded differing degrees of recognition to the practical reality of the manner in which enterprise groups operate. While the focus is still upon directors exercising their power for the benefit of their own group members, in some jurisdictions directors may nevertheless have regard to, for example, the direct or derivative commercial benefits accruing to that group member from a particular transaction with other group members and to the extent to which their group member's prosperity or continued existence depends on the well-being of the group as a whole. Typically, collective benefit is not a sufficient justification by itself. Moreover, directors might also be required to take into account any reasonably foreseeable detriments that might flow to their group member as a result of the transaction and consider the position of their group member's unsecured creditors, particularly where the transactions in question might affect that member's solvency. The latter consideration is of particular importance where the transaction is a guarantee or security for a loan to another group member.[4]

56. Other jurisdictions have allowed directors of group companies to act in the interests of the overall group where certain conditions are met, such as that the group has a balanced and firmly established structure; that the group member took part in the long-term and coherent group policy; and that the directors in good faith reasonably assumed that any detriment suffered by their group member would in due course be made good by other advantages. Another approach permits a director of a group member to act in the interests of the parent provided it does not prejudice the group member's ability to pay its own creditors and the directors are authorized, either by the constitution of the group member or by shareholders, depending on whether the group member is wholly or partly owned. The group member should not

[4] These considerations are similar to those referred to in recommendation 212 concerning the provision of post-commencement finance in the group context.

be insolvent at the time the director acts nor should it become insolvent by virtue of that action.

57. As noted in part three (paras. 75-80), some intra-group transactions might be found to be related person transactions and subject to avoidance in the context of insolvency. Under some laws, such transactions may also expose a director to personal liability if the group member was already insolvent or became insolvent as a result of the transaction. Other transactions or actions would not be covered by the related party provisions, such as decisions either not to act (e.g. not to compete with another group member for a particular opportunity) or to change the role of the company (e.g. by selling the member's assets externally either to run it down or to convert it into a "cashbox" for the group). Related party provisions do not require the interests of creditors to be considered.

(b) Definition of "director" in the group context

58. Paragraph 20 above discusses the second issue concerning the circumstances in which one group member or the director of a group member (e.g. of a holding company) might be considered a director, including a shadow director (footnote 6), of another group member. Some laws do not permit a group member to be appointed as a director of another group member, nevertheless, one group member might be regarded as a shadow director of another member. This may occur in numerous ways, such as where the boards of the two members consist of substantially the same persons, where the majority of the board of one group member is nominated by the other member, which is in a position of control, where one member controls the management and financial decision-making of the group and where one group member interferes in a sustained and pervasive manner in the management of another group member, typically in the situation of a parent and controlled group member.

59. Part three of the Legislative Guide discusses extending liability for external debts in the group context and notes (para. 99) that in a number of the examples where liability might be extended to the parent, that liability may include the personal liability of the members of the board of directors of the parent (who may be formally appointed, de facto or shadow directors). One of the principal difficulties with extending liability in such cases is proving the behaviour in question to show that the parent was acting as a de facto or shadow director of the other group member.

B. Issues for consideration

60. The Working Group may wish to consider whether additional recommendations are required to address the issues raised above. Is it desirable, for example, to enable a director of a company in the vicinity of insolvency to consider the interests of the group as a whole in addition to those of their own group member, or should the focus be upon their own group member exclusively? Secondly, the Working Group has agreed that a "director" for the purposes of this work should be determined in accordance with national law (see draft recommendation ...). Is that definition sufficiently broad to encompass considerations relevant to enterprise groups?

III. Cross-border issues

61. At its thirty-ninth and fortieth sessions, the Working Group agreed that cross-border issues should be considered at a future session (A/CN.9/715, para. 109 and A/CN.9/738, para. 52). The Working Group may wish to consider which of those issues should be further considered in the context of the current work and how they might be addressed.