




---

**United Nations Commission on  
 International Trade Law**  
**Working Group V (Insolvency Law)**  
**Forty-third session**  
 New York, 15-19 April 2013

## Insolvency Law

### Directors' obligations in the period approaching insolvency

#### Note by the Secretariat

#### Contents

	<i>Paragraphs</i>	<i>Page</i>
Introduction . . . . .	1-8	2
Directors' obligations in the period approaching insolvency. . . . .		4
Introduction and purpose of this [part] . . . . .		4
I. Background . . . . .	1-15	4
II. Elements of directors' obligations in the period approaching insolvency . . . . .	16-57	9
A. The nature of the obligations . . . . .	16-21	9
B. When the obligations arise: the period approaching insolvency . . . . .	22-25	13
C. Identifying the parties who owe the obligations. . . . .	26-29	15
D. Liability . . . . .	30-36	16
E. Enforcement of the directors' obligations on commencement of insolvency proceedings . . . . .	37-57	19



## 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 of Great Britain and Northern Ireland (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.<sup>1</sup> 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, forty-first and forty-second sessions (31 October-4 November 2011, Vienna; 30 April-4 May 2012, New York and 26-30 November 2012, Vienna). 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, A/CN.9/742 and A/CN.9/763, respectively).

5. The material set forth below builds upon documents A/CN.9/WG.V/WP.96, 100, 104 and 108, as well as decisions taken by the Working Group at its thirty-ninth, fortieth, forty-first and forty-second sessions. For ease of reference, this note retains in square brackets the paragraph and recommendation numbers used in previous drafts of the text (i.e. A/CN.9/WG.V/WP.104 and 108).

6. 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, the text below follows the format of the Legislative Guide. The Working Group may wish to consider whether it should be a new part of the Guide or whether it may be included as an additional section of an existing part, for example, part two, chapter III Participants. In accordance with a request made at the forty-second session, the order of the commentary now reflects the order of the recommendations and the recommendations no longer appear

---

<sup>1</sup> The first topic, concerning centre of main interests and related issues is discussed in A/CN.9/WG.V/WP.112.

together at the end of the text but follow the related parts of the commentary. Each set of recommendations is introduced by a purpose clause, consistent with the parts one-three of the Guide.

7. The Working Group may also wish to consider whether any specific terms should be included in a glossary for this [part].

8. The Working Group may wish to note that the following paragraphs contain new text in square brackets for consideration: introduction and purpose, paragraphs 1 and 2; Background, paragraph 2; section II, paragraphs 20 (d), (f), (j), 21, 21A, 22, 25, 33, 35, 36, 47, 48, 51, 55 and 57. Purpose clauses for draft recommendations 3-12 are for consideration, as well as some words in draft recommendations 1, 3, 6, 8 and draft recommendation 12 and its associated footnote.

## UNCITRAL Legislative Guide on Insolvency Law

### Directors' obligations in the period approaching insolvency

#### Introduction and purpose of this [part]

[1. This [part] focuses on the obligations that might be imposed upon those responsible for making decisions with respect to management of an enterprise when that enterprise faces imminent insolvency or insolvency becomes unavoidable. The aim of imposing such obligations, which would become enforceable once insolvency proceedings commence, is to protect the legitimate interests of creditors and other stakeholders and encourage timely action to minimize the effects of financial distress experienced by the enterprise. The constitution of a board of directors is an important factor in addressing these issues. Generally, it is comprised of individuals who have an ownership interest in the enterprise and individuals who work for the company, such as managing its business operations, or are connected to its shareholders ("inside directors"), along with individuals who are independent and are often chosen as a result of their experience and business acumen ("independent directors"). Independent directors may not have access to information to the same extent that it is known or available to inside directors or to creditors or third parties. Liability may vary between inside and independent directors depending on the factual situation.]

[2. The key elements of provisions imposing such obligations are addressed, including (a) the nature and extent of the obligations, (b) the time at which the obligations should arise, (c) the persons to whom the obligations would attach, (d) liability for breach of the obligations, (e) enforcement of those obligations, (f) applicable defences, (g) remedies, (h) the persons who may bring an action to enforce the obligations and (i) how those actions might be funded.]

## I. Background

1. [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<sup>2</sup> that include the obligations of those persons responsible for making decisions concerning the management of an enterprise (in this [part] referred to as "directors")<sup>3</sup> when it is solvent.

---

<sup>2</sup> See for example the OECD Principles of Corporate Governance, 2004.

<sup>3</sup> The question of who may be considered a director for the purposes of this [part] is discussed below in paras. ... . Although there is no universally accepted definition of the term, this part refers generally to "directors" for ease of reference.

2. [7] Once insolvency proceedings commence, many insolvency laws recognize that the obligations of 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. [Recommendation 112 addresses several possibilities for the role the debtor may play in the continuing operation of the business, including retention of full control, limited displacement and total displacement.] 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 obligations is also addressed (recommendation 114 and paragraphs 32-34 of the commentary).

3. [8] Effective insolvency laws, in addition to providing a predictable legal process for addressing the financial difficulties of troubled enterprises and the necessary framework for their efficient reorganization or orderly liquidation, should also permit an examination to be made of the circumstances giving rise to insolvency and in particular the conduct of directors of such an enterprise in the period before insolvency proceedings commence. 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. The nature and extent of the obligations directors might have in that period when the business might be experiencing financial distress but is not yet insolvent or subject to insolvency proceedings are not well established, but they are increasingly the subject of extensive debate, particularly in view of widespread failures following the global financial crisis of 2008.

4. [9] A business facing an actual or imminent inability to meet its financial and contractual obligations as they fall due needs robust management, as often there are difficult decisions and judgements to be made that will be critical to the company's survival, with corresponding benefits to its owners, creditors, customers, employees and others. 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 relevant stakeholders in the circumstances of the specific case. Under some laws, those stakeholders will be the corporation itself and its shareholders. Under other laws, it may involve a broader community of interests that includes creditors. Directors concerned with personal liability and 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.

5. [9A] The different interests and motivations of stakeholders are not easy for directors and managers to balance and provide a potential source of conflict. For example, shareholders of an 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 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 and leave 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.

6. [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 directors to take early action if that action cannot be directed towards relevant and effective procedures.<sup>4</sup> Moreover, those laws that expose directors to liability for 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 insolvency proceedings because the directors have failed to act in a timely manner.

7. [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 insolvency proceedings within a 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 through the use of restructuring negotiations or reorganization and to stop directors from externalizing the costs of the company's financial difficulties and placing all the risks of further trading on creditors.

---

<sup>4</sup> 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.

8. [12] The imposition of such obligations has been the subject of continuing debate. Those who acknowledge that such an approach has advantages<sup>5</sup> 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, the obligations may also have the effect of controlling and disciplining directors, 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 directors to obtain competent professional advice when financial difficulties loom.

9. [13] Those commentators who suggest that there are significant disadvantages cite the following examples. A rule that presumes mismanagement based solely on the fact of financial distress often causes otherwise knowledgeable and competent directors to leave a company, and the opportunity to reorganize that company and return it to profitability is missed. There is a possibility that directors seeking to avoid liability will prematurely close a viable business that otherwise could have survived, instead of attempting to trade out of the company's difficulties. Properly drafted provisions 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 and are more likely to balance the rights and legitimate expectations of all stakeholders, distinguishing cases of bad conduct from those involving market conditions or other exogenous factors. A further disadvantage cited is 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, however, would focus not so much on the causes of distress, but rather on the directors' acts (or omissions) subsequent to that point. Examples from jurisdictions that include such obligations in their laws suggest that only the most clearly irresponsible directors are found liable.

10. [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 may be inclined to second guess the decisions that directors took in the period in question. However, in jurisdictions with experience of enforcing such obligations, courts have tended 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.<sup>6</sup> It is also argued that imposing such obligations

---

<sup>5</sup> E.g. Directors in the Twilight Zone III (2009), INSOL International, Overview, p. 5.

<sup>6</sup> See para. 27 [21].

overcompensates creditors who are able to protect themselves through their contracts, making regulation superfluous. However, this approach presupposes that, for example, all creditors have a contract with the debtor, that they 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.

11. [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 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 such as company law, or subject to insolvency proceedings, which is addressed by insolvency law (although there are examples where no such clear distinction can be drawn).<sup>7</sup> A period before the commencement of insolvency proceedings, when a debtor may be factually insolvent, raises concerns that currently may not be adequately addressed by either company law or insolvency law. However, the imposition of obligations enforceable retroactively after commencement of insolvency proceedings may lead to an overlap between the obligations applicable under different laws and it is desirable that, in order to ensure transparency and clarity and avoid potential conflicts, they be reconciled.

12. [16] Not only do the laws in which the obligations are to be found vary, but the obligations themselves vary: as noted above, 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 the jurisdiction(s) in which the entity operates and may also depend upon whether the director is an independent outsider or an inside director.

13. [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.

14. [18] Effective regulation in this area should seek to balance the often competing goals and interests of different stakeholders: preserving the freedom of directors to discharge their obligations and exercise their judgement appropriately, encouraging responsible behaviour, discouraging wrongful conduct and excessive risk-taking, promoting entrepreneurial activity, and encouraging, at an early stage, the refinancing or reorganization of enterprises facing financial distress or

---

<sup>7</sup> Recognizing this issue, the recommendations in this [part] adopt the flexible approach of referring to “the law relating to insolvency”.

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, unclear, antiquated and inconsistent guidelines on the obligations of those responsible for making decisions with respect to 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 and exacerbate the financial difficulty they are intended to address.

15. [19] The purpose of this [part] is to identify basic principles to be reflected in the law concerning directors' obligations when the company faces imminent insolvency or insolvency becomes unavoidable. Those principles may serve as a reference point and can be used by policymakers 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 relevant law and become enforceable once insolvency proceedings commence.

## **II. Elements of directors' obligations in the period approaching insolvency**

### **A. The nature of the obligations**

16. [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 tend to focus upon two aspects — first, imposing civil liability on directors for causing insolvency or failing to take appropriate action in the vicinity of insolvency (which under some laws might include commencing insolvency proceedings pursuant to an obligation under national law to do so — see para. 17 [29]) and second, once insolvency proceedings have commenced, avoiding actions taken by directors, including transactions that may have been entered into, in the vicinity of insolvency.

#### **1. Obligation to commence insolvency proceedings**

17. [29] As noted above, some national 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 factually 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 more detail in part two, chapter I, paragraphs 35-36.

## 2. Civil liability

18. [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 that may result in a material increase in the creditors' exposure 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 company's financial situation to those creditors. Under some laws, liability may arise when directors fail to meet various obligations, for example reporting inability to make certain payments, such as tax and social security premiums, or making a formal declaration of insolvency.

19. [31] Except under those laws that require directors 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 be able to act to minimize losses to creditors and to the company (including to its shareholders), to avoid actions that would aggravate the situation, and to take appropriate action to avoid the company sliding into insolvency.

20. [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. Directors may need to devote more time and attention to the company's affairs at such a time than is required when the company is healthy;

(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 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. [In this instance, the directors, either collectively, as inside directors or as independent directors, may retain independent accountants, restructuring experts, or counsel to provide separate advice as to the options available to the board to determine the viability of any proposals made by management];

(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. [Directors may also consider the capacity of current management, with a view to determining whether it should be retained or replaced];

(g) Directors could ensure that they modify management practices to focus on a range of interested parties, which might include creditors, employees, suppliers, customers, governments, shareholders, as well as, in some circumstances, environmental concerns, in order to determine the appropriate action to take. In the period when insolvency becomes imminent or unavoidable, shifting the focus from maximizing value for shareholders to also 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), that might be the result of excessively risky, reckless or grossly negligent conduct. Holding meetings with relevant groups of creditors might be an appropriate mechanism for assessing those interests;

(h) Directors could ensure that the assets of the company are protected<sup>8</sup> and 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. 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;

---

<sup>8</sup> Not all assets will necessarily require protection in all circumstances. One example of the types of asset that might not require protection in all circumstances might be those that are worth less than the amount for which they are secured, are burdensome, of no value or hard to realize (this is discussed in more detail in part two, chap. II, para. 88).

(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);

[(j) The composition of the board could be reviewed to determine whether an adequate number of independent directors are included.]

### **3. Avoidance of transactions**

21. [33] Recommendations 87 through 99 deal 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). Those recommendations would apply to the avoidance of transactions entered into by a company in the vicinity of insolvency. [The avoidability of a transaction does not, on its own, serve as the basis for imposing personal liability on directors.]

21A. [33] [However, certain avoidable transactions may also have other consequences.] Some laws render certain actions of directors unlawful 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 business justification. In addition to avoidance of such transactions, under some laws a director may be found personally liable for permitting the company to enter into such [fraudulent or otherwise improper] transactions. Liability under those provisions 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.

### **Recommendations 1 and 2**

#### **Purpose of legislative provisions**

The purpose of provisions addressing the obligations of those responsible for making decisions concerning the management of a company that arise when insolvency is imminent or unavoidable is:

- (a) To protect the legitimate interests of creditors and other stakeholders;
- (b) To ensure that those responsible for making decisions concerning the management of a company 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.

## Contents of legislative provisions

### *The obligations*

1. The law relating to insolvency should specify that from the point in time referred to in recommendation 3, the persons specified in [accordance with] recommendation 4 will have the obligations to have due regard to the interests of creditors and other stakeholders and to take reasonable steps:

- (a) To avoid insolvency; and
- (b) Where it is unavoidable, to minimize the extent of insolvency.

2. [1] For the purposes of recommendation 1, reasonable steps might include:

(a) Evaluating the current financial situation of the company and ensuring proper accounts are being maintained and that they are up-to-date; being independently informed as to the current and ongoing financial situation of the company; holding regular board meetings to monitor the situation; seeking professional advice, including insolvency or legal advice; holding discussions with auditors; calling a shareholder meeting; modifying management practices to take account of the interests of creditors and other stakeholders; protecting the assets of the company so as to maximize value and avoid loss of key assets; considering the structure and functions of the business to examine viability and reduce expenditure; not committing the company to enter into the types of transaction that might be subject to avoidance unless there is an appropriate business justification; continuing to trade in circumstances where it is appropriate to do so to maximize going concern value; holding negotiations with creditors or commencing other informal procedures, such as voluntary restructuring negotiations;<sup>9</sup>

(b) Commencing formal reorganization or liquidation proceedings where it is appropriate to do so or where it is required by national law.

## **B. When the obligations arise: the period approaching insolvency**

22. [24] The point at which the obligations discussed above might arise has been 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 a period in which there is a deterioration of the company’s financial stability to the extent that insolvency has become 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. 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 the point in time [in the period before insolvency proceedings commence] to which a court would have reference in considering an action for breach of those obligations.

23. [25] There are various possibilities for determining the time at which directors’ obligations might arise in the period before commencement of insolvency proceedings and different approaches are taken. One possibility may be the point at

<sup>9</sup> See UNCITRAL Legislative Guide on Insolvency Law, part one, chapter II, paras. 2-18.

which an application for commencement of insolvency proceedings is made, arguably the possibility that delivers 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 in terms of encouraging directors to take early action.

24. [26] Another possibility focuses on the obligations arising when a company is factually 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, however, are increasingly used in insolvency laws as commencement standards and in some States form 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. Accordingly, these tests are also unlikely to encourage appropriate steps to be taken at a sufficiently early time.

25. [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 or that insolvency was imminent and there was no reasonable prospect that the company could avoid having to commence insolvency proceedings or that the continuity of the business was threatened. [The rationale of this approach is to catch directors who are unreasonable in their running of a company that is experiencing financial difficulty and to provide incentives to take appropriate action at an optimal time.] Although a 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, provided a company's accounts have been properly kept and are accurate, a director should be able to deduce when the company is in difficulty and when it might be in danger of satisfying these insolvency tests. 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. 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. 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.

### **Recommendation 3**

#### **Purpose of legislative provisions**

[The purpose of provisions relating to timing is to identify when, in the period before the commencement of insolvency proceedings, the obligations should arise.]

## Contents of legislative provisions

### *The time at which the obligation arises*

3. [2] The law relating to insolvency should specify that the obligations in recommendation 1 arise at the point in time when the person specified in [accordance with] recommendation 4 knew, or ought reasonably to have known, that insolvency was imminent or unavoidable.

## C Identifying the parties who owe the obligations

26. [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, (who may be independent outsiders or officers or managers of a company serving as executive directors, referred to as "inside directors") and non-appointed individuals and entities, including third parties acting as de facto<sup>10</sup> or "shadow" directors,<sup>11</sup> as well as persons to whom the powers or duties of a director may have been delegated by the directors.<sup>12</sup>

<sup>10</sup> 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.

<sup>11</sup> 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.

<sup>12</sup> Note to the Working Group: The following text may be included in any material to prepared with respect to enterprise groups or otherwise deleted. — 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 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.

27. [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.

28. [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 or do in fact make or ought to make key decisions with respect to the management of a company, including functions such as the following:<sup>13</sup> 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.

29. [22] The obligations discussed above 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 resigned (see para. 40 below). It would not include a director appointed after the commencement of insolvency proceedings.

#### **Recommendation 4 [3]**

##### **Purpose of legislative provisions**

[The purpose of the provisions is to identify the persons to whom the obligations should apply.]

##### **Contents of legislative provisions**

###### *Persons that owe the obligations*

4. [3] The law relating to insolvency should specify the person who owes the obligations, which may include any person formally appointed as a director and any other person exercising factual control and performing the functions of a director.

## **D. Liability**

### **1. The standard to be met**

30. [34] Laws dealing with the obligations of directors in the vicinity of insolvency judge the behaviour of directors in that period against a variety of

---

<sup>13</sup> These examples are provided for information and are not listed in any particular order of importance.

standards to determine whether or not they have failed to meet these obligations. [24] Typically those obligations only become enforceable once insolvency proceedings commence and as a consequence of that commencement, apply retroactively in much the same way as avoidance provisions (see discussion at part two, chap. II, paras. 148-150, 152).

31. [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.

32. [36] Another approach requires there to be reasonable grounds for suspecting the company was insolvent or would become insolvent at the time of incurring the debt or entering into the transaction leading to insolvency. Reasonable grounds for suspecting insolvency would require more than mere speculation and the director must have an actual apprehension that the company is insolvent. This is a lower threshold than expecting or knowing the company is insolvent. Under this approach, 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 takes place, 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.

33. [38] Some laws provide a safe harbour for directors, such as by way of a business judgement rule, that 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. [Provided the actions of the director were taken in good faith, with due care and within the director's authority, they will be shielded from liability. To rely upon the rule, directors must inform themselves with respect to the matters to be decided by acquiring, studying and relying upon information that a reasonable person in similar circumstances would find persuasive and be free from any conflict of interest with respect to those matters.]

34. [37] A further approach focuses on mismanagement. Laws adopting this approach 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 under those laws 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 a 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. Under some laws that adopt this approach, a finding of mismanagement does not require that a director have actively engaged in the management of the company; passive acquiescence may be sufficient.

## **2. The nature of the liability**

35. [32A] [Whether a particular director has breached their obligations involves consideration of the personal circumstances of that director. Once a breach of the obligations has been determined under the relevant standard of proof, liability can be apportioned in several ways. Under one approach, liability will be apportioned to individual directors in proportion to their specific involvement in the decisions or behaviour under examination, requiring consideration of that involvement in the totality of the circumstances.]

36. [32A] [A number of other laws establish the general rule that directors will be held jointly and severally liable for their failure to meet such obligations. This may be the case even if each director is not responsible for the performance of all relevant obligations. Some of these laws provide, however, that the court may still have the discretion to allocate contributions as between directors taking into account the facts of the case, including different levels of culpability. The court may, for example, order one of a number of directors to bear the whole burden of liability (where, for example, that director had been personally assigned specific obligations that relate to the damage under examination) or order one director to contribute more when, for example, it is found that culpability for the damage caused is not equal. Under one law, directors may be jointly and severally liable only if it is established that they knowingly engaged in fraud or dishonesty; in all other cases, liability is proportionate to the extent a director's actions contributed to the loss to the company. Another law adopts a slightly different approach in which the court determines whether a person found liable must pay damages to the company, based upon the seriousness of the fault and the strength of the causal link, but the assessment of damages is not necessarily proportionate to the level of responsibility or fault. Under some laws, the issue of whether liability is joint or allocated specifically to those directors responsible for the conduct in question (which may include failure to act or to ensure that other directors meet their own obligations) depends upon the action giving rise to liability.]

## Recommendations 5 and 6

### Purpose of legislative provisions

[The purpose of provisions on liability is:

(a) To provide rules for the circumstances in which the actions of a person subject to the obligations in recommendation 1 that occur prior to the commencement of insolvency proceedings may be considered injurious and therefore a breach of those obligations; and

(b) To identify the consequences of that breach.]

### Contents of legislative provisions

#### *Liability*

5. [4] The law relating to insolvency should specify that where creditors have suffered loss or damage as a consequence of the breach of the obligations in recommendation 1 the person owing the obligations may be liable.

6. [4] The law relating to insolvency should provide that the liability [for] [arising from] breach of the obligations in recommendation 1 is limited to the extent to which the breach caused loss or damage.

## E. Enforcement of the directors' obligations on commencement of insolvency proceedings

### 1. Defences

37. [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. 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 obligations specified under the law.

38. [39] Under some laws, 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 as a defence even if those decisions turn out to have been commercially wrong.

39. [32B] Some laws also provide for directors to take certain procedural or formal steps to avoid or reduce their liability for decisions or actions that are subsequently called into question, such as entering a dissent in the minutes of a meeting; delivering a written dissent to the secretary of a meeting before its adjournment; or delivering or sending a written dissent promptly after the adjournment of a meeting to the registered office of the corporation or other authority as provided under

national law. 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.

40. [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.

41. [32C] Liability may be minimized through specific insurance, which may be purchased by the company for its directors, or by the use of indemnities. [Where insurance is available, the principal limits are typically deliberate fraud and self-dealing, leaving directors generally covered for breach of the obligations discussed here unless the insurance coverage is inadequate, as may occur in insolvency.] 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.

## 2. Remedies

42. [41] Different remedies and combinations of remedies for breach of a director's obligations are provided under 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. Typically, there is no punitive damages element. [A number of] [Many] 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*

43. [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. 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.

44. [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 make provision for the award of damages.

45. [44] 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. Some laws provide that where the company has an all-enterprise mortgage, any damages recovered are for the benefit of unsecured creditors. It may be argued in support of that approach 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 remedy the damage suffered by creditors. Where, however, the insolvency law permits creditors to pursue directors (see below), there may be grounds for suggesting that any compensation to be paid might be applied, in the first instance, to cover the costs of the creditor or creditors commencing the action.

46. [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 the obligations.

(b) *Disqualification*

47. [46] A consequence provided for under [a number of] [many] 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 those 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 persons found to be unfit often, though not always, have displayed a lack of commercial probity, gross negligence or serious incompetence.

48. [47] Disqualification may sit alongside other remedies and sanctions as described above, or may be sought independently where the overall conduct of the individual as a director merits such a sanction. [Where disqualification is available, the persons who may seek it may be limited to specified agencies or officials, the insolvency representative and, in some cases, creditors.]

### **3. Persons who may bring an action**

49. [48] A number of laws limit the right to bring an action against a director for breach of the obligations discussed above by reference to the nature of the action and the person with the power to pursue it. 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.

50. [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 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.

51. [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). [Where the benefit of any damages assessed will accrue to the insolvency estate for the benefit of creditors, there may be little incentive for shareholders to pursue such an action. Other laws only allow creditors to pursue certain types of actions or transactions, such as misfeasance or transactions at an undervalue.] Under other laws, where creditors have no independent right to pursue a claim, a single creditor can pursue a director only 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.

52. [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 an action 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 vicinity of insolvency 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 actions may have on administration of the estate.

53. [49C] Where the consent of the insolvency representative or creditors is required, but not obtained or is 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 action should not go ahead. At such a hearing, the court might give leave for the action 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 actions or allow sanctions to be imposed on creditors to discourage potential abuse of those actions; the same approach might be adopted with respect to actions brought by creditors against directors.

54. [50] Under those laws imposing an obligation on directors to commence insolvency proceedings, the company itself, its shareholders and creditors may have a claim for damages in the event of a breach of that obligation. 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. It is desirable that the insolvency law ensure coordination of any actions that might potentially be commenced by these different parties.

55. [Litigation involving the obligations of directors of a company subject to insolvency proceedings is likely to be not only costly, but also time consuming and can operate to postpone the completion of the related insolvency proceedings. Although beyond the scope of this discussion, this is an issue that might merit consideration in order to reduce the effects of such litigation on those related actions.]

#### **4. Funding of actions**

56. [51] A potential difficulty arising in those jurisdictions that permit an insolvency representative to bring an action for breach of these obligations relates to payment of their costs in the event that it 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 when 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.

57. [51] 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. [Obtaining such alternative funding would be

assisted by including appropriate authorization in any law relating to insolvency in much the same way as is provided by recommendation 95 with respect to the funding of avoidance proceedings.] 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.

## **Recommendations 7-11**

### **Purpose of legislative provisions**

[The purpose of provisions on enforcement of the obligations is to establish appropriate remedies for breach of the obligations and facilitate the commencement and conduct of actions to recover compensation for that breach.]

### **Contents of legislative provisions**

#### *Elements of liability and defences*

7. [5] The law relating to insolvency should specify the elements to be proved in order to establish a breach of the obligations in recommendation 1 and that, as a consequence, creditors have suffered loss or damage; the party responsible for proving those elements; and specific defences to an allegation of breach of the obligations. Those defences may include that the person owing the obligations took reasonable steps of the kind referred to in recommendation 2.

#### *Remedies*

8. [6] The law relating to insolvency should specify that the remedies for liability found by the court to arise from a breach of the obligation in recommendation 1 should include payment in full to the insolvency estate of any damages assessed by the court [as compensation for that breach]. Failure to pay such damages in full should limit the person owing the obligation from exercising a set-off with respect to any debts owed by the company to such person until payment in full is made.

#### *Conduct of actions for breach of the obligation*

9. [7] The law relating to insolvency should specify that the cause of action for loss or damage suffered as a result of the breach of the obligations in recommendation 1 belongs to the insolvency estate and the insolvency representative has the principal responsibility for pursuing an action for breach of those obligations. The law relating to insolvency may also permit, with the agreement of the insolvency representative, a creditor or any other party in interest to commence such an action. When the insolvency representative does not agree, the

creditor or other party in interest may seek leave of the court to commence such an action.

*Funding of actions for breach of the obligation*

10. [8] The law relating to insolvency should specify that the costs of an action against the person owing the obligations be paid as administrative expenses.

11. [9] The law relating to insolvency may provide alternative approaches to address the pursuit and funding of such actions.

*Additional measures*

[12. [10] In order to deter behaviour of the kind leading to liability under recommendation 5, the law relating to insolvency may include remedies additional<sup>14</sup> to the payment of [compensation] [damages] provided in recommendation 8.]

---

[<sup>14</sup> The additional remedies that may be available will depend upon the types of remedies available in a particular jurisdiction and what, in addition to the payment of compensation, might be proportionate to the behaviour in question and appropriate in the circumstances of the particular case. Examples of such remedies are discussed in paras. ... [of the commentary].]