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Insolvency Law

Directors' obligations in the period approaching insolvency: enterprise groups

Note by the Secretariat

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Introduction

1. Part three of the UNCITRAL Legislative Guide on Insolvency Law deals with the treatment of enterprise groups in insolvency and provides background on the nature of enterprise groups; reasons for conducting business through enterprise groups; what constitutes an enterprise group by reference to concepts such as ownership and control; and regulation of enterprise groups. Part four of the Legislative Guide addresses the obligations of directors in the period approaching insolvency, discussing issues associated with directors' obligations in that period and, in particular, the rationale for imposing obligations specific to that period by way of the operation of insolvency, rather than corporate, law. Neither part three nor part four addresses the specific issues that might affect directors' obligations when they are directors of one or more enterprise group members.

2. At its forty-fourth session (2013), Working Group V (Insolvency Law) agreed on the importance of addressing the obligations of directors of enterprise group companies in the period approaching insolvency, given that there were clearly difficult practical problems in this area and that solutions would be of great benefit to the operation of efficient insolvency regimes. At the same time, the Working Group noted that there were issues that needed to be considered carefully so that solutions would not hinder business recovery, make it difficult for directors to continue to work to facilitate that recovery, or influence directors to prematurely commence insolvency proceedings. In light of those considerations, the Working Group agreed that it would be helpful to have the next steps taken informally in an expert group whose task would be to examine how part four of the UNCITRAL Legislative Guide could be applied in the enterprise group context and any additional issues (such as conflicts between a director's obligations to its own company and the interests of the group and issues of governing law) that might need to be addressed. The informal expert group was to report back to the Working Group no later than the session in the second half of 2014 (A/CN.9/798, para. 23).

3. This working paper has been prepared by the Secretariat following consultations with an informal expert group as requested by Working Group V. It builds upon the relevant recommendations of part four of the UNCITRAL Legislative Guide (recommendations 255-266) and indicates the manner in which those recommendations might be modified to specifically address directors' obligations in the enterprise group situation. The focus is upon recommendations 255 and 256 which outline the obligations to be met and the reasonable steps to be taken to satisfy those obligations in the group context. The proposed modifications to those recommendations could be accompanied by relevant explanatory commentary to assist the reader in understanding the modified recommendations and how they might be applied. Such explanatory material has not been included in this paper, but could be drafted once the Working Group has decided upon its approach to preparing a draft text on this topic.

4. Recommendations to which modifications are not proposed are not included in the recommendations set forth below, but would apply to the group context (i.e. recommendations 257 and 259-266). The appropriateness of recommendation 258 as drafted for the group context is raised. As to terminology, the word "company" as used in part four of the Legislative Guide has been replaced with the words "enterprise group member" as appropriate.

I. The nature of the obligations: recommendations 255-256 (EG)

A. Draft recommendations

1. Purpose of legislative provisions

[These provisions address the situation of a company facing imminent or unavoidable insolvency where it is a member of an enterprise group.]

The purpose of these provisions addressing the obligations of those responsible for making decisions concerning the management of an enterprise group member that arise when insolvency is imminent or unavoidable is:

(a) To protect the legitimate interests of creditors and other stakeholders [of enterprise group members];

(b) To ensure that those responsible for making decisions concerning the management of an enterprise group member 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;

[(d) To recognize the impact of the enterprise group member's position in the enterprise group upon the manner in which the group member should be managed to address its imminent or unavoidable insolvency and the obligations of those responsible for making decisions concerning the management of that group member, including in situations where they are also responsible for making decisions concerning the management of other group members]; and

[(e) To permit an enterprise group member to be managed, where appropriate, in a manner that [is ultimately in the best interests of the enterprise group] [will maximize value in the enterprise group] [and of the group member as part of that enterprise group] [whilst ensuring that the creditors of that group member and its other stakeholders are no worse off than if a solution for the individual group member had been pursued]].

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

(a) Adversely affect successful business reorganization [of the enterprise group] [of the enterprise group member, taking into account the possible benefit of maximizing the value of the enterprise group and promoting an insolvency solution for the enterprise group as a whole, the position of the group member in the enterprise group and the degree of integration between group members];

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

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

2. Content of legislative provisions

The obligations

255 (EG). The law relating to insolvency should specify that from the point in time referred to in recommendation 257, the persons specified in accordance with recommendation 258 will have the obligations to have due regard to the interests of creditors and other stakeholders [of the enterprise group member [of which they are a director] and of other group members] and to take reasonable steps:

(a) To avoid insolvency; and

(b) Where it is unavoidable, to minimize the extent of insolvency [and its impact on creditors and other stakeholders of the enterprise group member and of other group members] [, taking into account the possible benefit of maximizing the value of the enterprise group and promoting an insolvency solution for the enterprise group as a whole, the position of the enterprise group member in the enterprise group and the degree of integration between enterprise group members].

256 (EG). For the purposes of recommendation 255 (EG), reasonable steps might include, [in addition to the steps outlined in recommendation 256]:

(a) Evaluating the current financial situation of the enterprise group member [and of the enterprise group] [to ascertain whether more value might be preserved or created by considering a solution for the enterprise group as a whole];

(b) [Considering the financial and other obligations of the group member to other group members, which transactions should be entered into with other enterprise group members, and possible sources and availability of post-commencement finance];

(c) Calling a shareholder meeting [with the parent and other enterprise group members to discuss how to structure the analysis of the insolvency solution for the individual group member and the enterprise group as a whole, taking into account issues of applicable law];

(d) [Evaluating whether the enterprise group member's creditors and other stakeholders would be better off under an insolvency solution for the enterprise group as a whole and assisting the implementation of such a solution];

(e) Being independently informed as to the current and ongoing financial situation of the enterprise group member [and of the enterprise group];

(f) Seeking professional advice, including [independent] insolvency or legal advice;

(g) Holding and participating in informal negotiations with creditors, such as voluntary restructuring negotiations,¹ [where organized for the enterprise group as a whole or for several enterprise group members];

(h) Considering the structure and functions of the business [in the context of the enterprise group] to examine viability and reduce expenditure;

(i) Not committing the enterprise group member to the types of transaction that might be subject to avoidance unless there is an appropriate business

¹ Legislative Guide, part one, paras. 2-18.

justification [for entering into such transactions] [, which could include a business justification in the context of the enterprise group]; and

(j) Commencing or requesting the commencement of formal reorganization or liquidation proceedings. [Where formal proceedings are to be commenced, considering the court in which they should be commenced, whether a joint application² with other relevant enterprise group members is possible or appropriate and whether proceedings should be procedurally coordinated.³]

B. Notes

(a) Purpose clause

5. This purpose clause is based on the purpose clause for recommendations 255 and 256 of part four of the UNCITRAL Legislative Guide. Proposed additions, shown in square brackets, are intended to introduce the impact the enterprise group context might have on the nature of the obligations and the manner in which they can be discharged. Language from recommendations 214 and 217 of part three of the Legislative Guide has been added to draw attention to that context. While the primary obligations of directors relate to the individual group member to which they have been appointed, there are additional factors that might need to be taken into account, for example, the position of the group member in the enterprise group, the degree of integration between group members, and the possible benefits of maximizing the value of the enterprise group and of promoting an insolvency solution for the group as a whole.

(b) Recommendation 255 (EG)

6. Recommendation 255 refers directly to the obligations of the directors of the group member that is imminently or unavoidably facing insolvency. In the enterprise group context, the obligations to avoid or, particularly, to minimize the impact of insolvency may need to take account of factors beyond the particular group member. There may be circumstances, for example, where the best way of preserving the value of the group member and the interests of its creditors and other stakeholders will be to contribute to and participate in a broader solution for the enterprise group as a whole (or some part of the group). In such a case, a director's primary obligations remain to the group member to which they have been appointed and they will need to ensure that their creditors and other stakeholders are no worse off under the solution adopted for the group as a whole than they would have been had a solution for the individual group member been pursued. Those ideas are included in the modified recommendation; specific steps to be considered are included in recommendation 256 (EG). Situations likely to give rise to conflicting obligations, such as where a director of the group member imminently or unavoidably insolvent is also a director of another group member or holds an executive or management position in another group member, is addressed in a new draft recommendation (see below).

² Legislative Guide, part three, recommendations 199-201.

³ Legislative Guide, part three, recommendations 202-210.

(c) Recommendation 256 (EG)

7. Recommendation 256 of part four of the Legislative Guide remains relevant in the group context and a number of steps outlined in that recommendation have not been repeated here as they require no modification for the group context. Other steps have been repeated and expanded and several new steps have been added to take account not only of actions required to be taken by directors with respect to the enterprise group member to which they have been appointed, but also actions that necessarily involve the parent and other group members, reflecting the position of the group member within the enterprise group and its relationship to other group members.

8. Where formal insolvency proceedings need to be commenced, it may be appropriate to introduce some of the mechanisms recommended in part three of the Legislative Guide with respect to domestic enterprise groups to facilitate the conduct of proceedings affecting two or more enterprise group members, in this case joint application for commencement and procedural coordination.

II. Conflicting obligations

A. Draft recommendation

1. Purpose of legislative provisions

[The purpose of provisions on conflict of obligations is to address the situation where a director of one enterprise group member holds that position or a management or executive position in another or other enterprise group members, whether the parent or a controlled group member. That situation may give rise, in the period approaching insolvency, to a conflict between the obligations owed to the different group members, which may have an impact upon the taking of steps required to discharge those obligations.]

2. Content of legislative provisions

256 (EG) bis. [The law relating to insolvency should address the situation where, in the period approaching insolvency, a director of one enterprise group member who holds that position, [or a management or executive position] in another or in other enterprise group members [, whether the parent or a controlled group member] has a conflict between the obligations owed to [the creditors of] those different group members.]

256 (EG) ter. [The insolvency law may specify that a director faced with such conflicting obligations should take reasonable steps to manage those conflicts, including obtaining advice to establish the exact nature of the different obligations, disclosing to creditors and other stakeholders situations likely to lead to conflicting obligations, appointing an additional director when the conflicting obligations cannot be reconciled and resigning where there is no alternative course of action available and resignation will not exacerbate the situation.]

B. Notes

9. This draft recommendation addresses the situation, common in enterprise groups, where a director holds that position in two or more group members, often including the parent. A director of one group member may also hold a management or executive position in another group member. Such a director may find that there is a conflict between the interests of the different group members and the obligations owed to the different group members. Such a conflict is likely to affect the director's ability to independently assess what action is required to address the financial difficulty of each of those group members and to take the reasonable steps outlined in recommendation 256 (EG). To avoid a situation where one group member is disadvantaged in favour of another group member, the insolvency law might specify that certain measures be taken to identify and manage such a conflict of interest. Those measures might require that for each group member adequate consideration is to be given to the steps outlined in recommendation 256 (EG), that the conflict should be managed in a way that does not disadvantage the creditors of the affected group members, that resignation⁴ is only to be used as a solution where it will not exacerbate the situation and that a director with obligations to several group members cannot use the obligations to one group member as a defence to the treatment afforded to another group member.

III. Identifying the parties who owe the obligations: recommendation 258

A. Recommendation

1. Purpose of legislative provisions

The purpose of the provisions is to identify the persons owing the obligations in recommendation 255.

2. Contents of legislative provisions

Persons owing the obligations

258. The law relating to insolvency should specify the person owing the obligations in recommendation 255, which may include any person formally appointed as a director and any other person exercising factual control and performing the functions of a director.

B. Notes

10. Part four of the UNCITRAL Legislative Guide is limited to formally appointed directors or any person exercising factual control and performing the functions of a director. Paragraph 15 of chapter II of the commentary to part four gives a broader indication of who might be included within the scope of part four, such as those

⁴ See Legislative Guide, part four, chapter II, paragraph 27, which discusses resignation in the context of defences available to directors.

charged with making, those who actually make and those who ought to make key decisions with respect to the management of the company and provides a list of key functions as examples.

11. The Working Group might wish to consider whether the formulation of recommendation 258 is broad enough in the enterprise group context to capture all of those who ought to owe the obligations in recommendation 255 (EG) or whether any further guidance ought to be provided for consideration. Commentators cite examples of jurisdictions in which adherence to the single entity notion and a narrow interpretation of relevant laws that typically ignores the reality of enterprise groups, results in a very high standard of proof. Accordingly, it can be particularly difficult, and even a highly speculative venture, to try to establish breach of obligations such as those provided by recommendation 255 (EG) by, for example, shadow directors such as, depending on the circumstances, the enterprise group parent.⁵ Courts are typically cautious about interfering with the concepts of corporate personality and limited liability. One approach may be to retain the current drafting of recommendation 258 and discuss the possible application of the provision in the enterprise group context and, in particular, where other group members function as shadow directors, in the commentary.

⁵ Irit Mevorach, *The Role of Enterprise Principles in Shaping Management Duties at Times of Crisis*, *European Business Organization Law Review* 14:471-496, p. 486.