



General Assembly

Distr.: Limited
23 February 2016

Original: English

**United Nations Commission on
International Trade Law**
Working Group V (Insolvency Law)
Forty-ninth session
New York, 2-6 May 2016

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 addresses the specific issues that might affect the obligations of directors who perform that function for one or more enterprise group members.

2. At its forty-fourth session (December 2013), the Working Group 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 that 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 possible solutions needed to be considered carefully so that they did 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 an examination of how part four of the Legislative Guide could be applied in the enterprise group context and identification of additional issues (e.g. conflicts between a director's obligations to its own company and the interests of the group) would be helpful.

3. Deliberations on this topic commenced at the Working Group's forty-sixth session (December 2014) on the basis of a draft prepared by the Secretariat following consultation with an informal expert group as requested by the Working Group (A/CN.9/WG.V/WP.125) and continued at its forty-seventh session (May 2015) on the basis of a revised draft (A/CN.9/WG.V/WP.129).

4. This note has been prepared by the Secretariat on the basis of the deliberations and conclusions of the Working Group at its forty-seventh session (A/CN.9/835, paras. 13-21). Set out below are revisions to draft recommendations 267 to 270 and the accompanying commentary. Proposed additions and revisions to the commentary are included in square brackets, with explanations as appropriate included in the footnotes.

UNCITRAL Legislative Guide on Insolvency Law, part four: Directors' obligations in the period approaching insolvency — enterprise groups

Introduction and purpose of this section

1. This second section of part four builds upon recommendations 255 to 266 of the first section, which address the obligations of directors of an individual company in the period approaching insolvency. Focusing on the nature of the obligations and the steps that might be taken to discharge those obligations (as established in recommendations 255 and 256), this section proposes how those recommendations could be revised for application in the context of enterprise groups. Recommendations 257 to 266 of the first section of part four continue to apply in the enterprise group context as drafted, however cross-references in those recommendations to recommendations 255 and 256 should be read for the purposes of this additional section as references to recommendations 267 and 268.
2. Additional recommendations (recommendations 269 and 270) have been added to this section to address the situation where a director is appointed to, or holds a managerial or executive position in, more than one group member and conflicts arise in discharging the obligations owed to the different members.
3. This section uses the same terminology as other parts of the Legislative Guide. To provide orientation to the reader, this section should be read in conjunction with part three and the first section of part four.

I. Background

4. The first section of part four of the Legislative Guide considers the obligations of directors of individual companies in the period approaching insolvency, providing information on how those obligations are treated under current laws. While some jurisdictions have developed provisions to impose obligations on directors in the period approaching insolvency, the relative advantages and disadvantages of such regimes remain the subject of debate.¹ The first section of part four underlines the need for early action to be taken when businesses face financial difficulty in order to avoid rapid decline and to facilitate rescue and reorganization. It also notes that while there has been an appropriate refocusing of insolvency laws in many countries towards increasing the options for that early action to be taken, there has been little corresponding attention paid to creating appropriate incentives for directors to use those options.² The first section encourages the development of appropriate incentives by identifying, for incorporation in the law relating to insolvency, the basic obligations a director of an enterprise may have in the period approaching insolvency and the steps that might be taken to discharge those obligations. Those obligations would become enforceable only when insolvency proceedings have commenced.

¹ Legislative Guide, part four, chap. I, paras. 8-10.

² *Ibid.*, para. 6.

5. In the enterprise group context, the issue of directors' obligations in the period approaching insolvency does not appear to be clearly or widely addressed by national legislation. While the concept of enterprise groups has been considered and developed in many jurisdictions, the question of the obligations of directors of one or more members of those enterprise groups remains somewhat uncertain.³

6. Part three of the Legislative Guide, which addresses the insolvency treatment of enterprise groups, notes that enterprise groups are often characterized by varying degrees of economic integration (from highly centralized to relatively independent) and types of organizational structure (vertical or horizontal) that create complex relationships between group members and may involve different levels of ownership and control. Those factors, together with adherence to the single entity principle and the widespread lack of any explicit acknowledgement of the group reality in the legislation applicable to individual group members, raise a number of issues for directors of enterprise group members. Adherence to the single entity principle typically requires directors to promote the success and pursue the interests of the company they direct, respecting the limited liability of that company and ensuring that its interests are not sacrificed to those of the enterprise group, irrespective of the interests of the group as a whole, the position of the director's company in the group structure, the degree of independence or integration among group members and the incidence of ownership and control. But where that company's business is part of an enterprise group and reliant, at least to some extent, on other group members for the provision of vital functions (e.g. financing, accounting, legal services, suppliers, markets, management direction and decision-making or intellectual property), addressing the financial difficulties of that company in isolation is likely to be difficult, if not, in some cases, impossible. [Indeed, adhering to a strictly narrow interpretation of the director's obligations may bring about the failure that it is hoped to avoid.] Part three discusses in some detail the current economic reality of enterprise groups and, in the context of insolvency, the impact of treating enterprise group members as unrelated entities on resolving the financial difficulties of some group members or of the group more widely.⁴

7. The requirement to act in the interests of the directed company may be further complicated in the group context when a director of one group member performs that function or holds a managerial or executive position in other group members. In such a situation, it may be difficult for the director to separately identify the interests of each of those group members and treat them in isolation. [Moreover, the interests of those group members may be affected by the possibly competing economic goals or needs of other group members and those of the enterprise group collectively. The short and long term implications for the interests of the different group members may need to be assessed, which may involve accepting, even if only in the short term, some detriment to the interests of individual group members in order to achieve a longer term benefit for the enterprise group to which those individual members belong. Where a group insolvency solution is pursued, it is reasonable that some safeguards would apply.]⁵

³ A/CN.9/WG.V/WP.115, para. 40, which outlines the manner in which a number of different jurisdictions address this issue.

⁴ Legislative Guide, part three, chap. I.

⁵ The changes to this paragraph address some of the concerns expressed at the forty-seventh session, A/CN.9/835, para. 17.

8. Some examples of situations in which the interests of individual group members may be affected by those of the group more widely may include where one group member is a key supplier, or provides finance to another group member or acts as a guarantor for finance provided by an external lender to another group member, in an attempt to keep the group as a whole afloat, including its own business; where one group member agrees to transfer its business or assets or surrender a business opportunity to another group member or to contract with that member on terms that could not be considered commercially viable, but where to do so may ultimately benefit the business of group member agreeing to the transfer; or where a group member enters into cross-guarantees with other group members to assist the group as a whole to use its assets more effectively in financing group operations.

9. Such considerations might be relevant in the period approaching insolvency, when greater control and coordination of the groups' activities may be required to maximize efficiency and design solutions to resolve the financial difficulties of the group as a whole or for some of its parts. At that time, there may also be more opportunities for advantage to be taken of more vulnerable and dependent group members in order to benefit other members, such as through transfers of assets, diversion of business opportunities and use of those group members to conduct more risky transactions or activities or to absorb losses and bad assets.

10. To address the best interests of the directed group member, a director may require a degree of flexibility to weigh the various competing interests and act for the benefit of other group members or the group as a whole where that action coincides with the best interests of the directed member. To the extent that the course of action a director chooses to follow in such circumstances is reasonable and directed to avoiding insolvency or minimizing its impact on the directed group member, they should not be liable for breach of their obligations. [Where having weighed the competing interests of the directed group members, the course of action chosen gives rise to a conflict between the obligations the director owes to those different group members, that conflict should be disclosed to the affected group members. Resolving such a conflict might require mediation or negotiation of the opposing interests.]

11. While, as noted above, few laws address directors' obligations in the enterprise group context, courts in different jurisdictions have accorded differing degrees of recognition to the practical reality of the manner in which enterprise groups operate. While the focus is still upon directors exercising their powers for the benefit of their own group member or members, some jurisdictions may permit directors to have regard, for example, to the direct or derivative commercial benefits accruing to that group member from pursuing a particular course of action with other group members and to the extent to which their group member's prosperity or continued existence depends on the well-being of the group as a whole. Typically, however, collective benefit is not a sufficient justification by itself [for acts judged to be prejudicial to creditors.] Moreover, directors might also be required to take into account any reasonably foreseeable detriments that might flow to their group member as a result of the course of action taken and to consider the position of their group member's unsecured creditors, particularly where that member's solvency might be affected. The latter consideration is of particular importance where the transaction is a guarantee or security for a loan to another group member,

[especially where the survival of that other group member is not critical to the solvency of the group member giving the guarantee or security].

12. Other jurisdictions have allowed directors of group companies to act in the interests of the overall group when certain conditions are met, such as that the group has a [structure that affords group members some influence in the overall decisions]; that the group member took part in the long-term and coherent group policy; and that the directors in good faith reasonably assumed that any detriment suffered by their group member would in due course be made good by other advantages. Another approach permits a director of a group member to act in the interests of the parent provided it does not prejudice the group member's ability to pay its own creditors and the directors are authorized, either by the constitution of the group member or by shareholders. Under those laws, for the director to avoid liability, the group member should not be insolvent at the time the director acts, nor should it become insolvent by virtue of that action.

13. This section identifies the extent to which a director of an enterprise group member may take account of considerations beyond the group member they direct in fulfilling their obligations in the period approaching insolvency and the safeguards that should apply. Those considerations will, to a greater or lesser extent, reflect aspects of the economic reality of the enterprise group. This section proposes principles for inclusion in the law concerning the obligations of directors of enterprise group companies in the period approaching insolvency. These 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 insolvency law (outlined in part one, chapter I, paragraphs 1-14 and recommendation 1) through early action and appropriate behaviour by directors, it is also acknowledged that there are threats and pitfalls for entrepreneurs that may result from overly draconian rules.

14. This section does not deal with the liability of directors under criminal law, company law or tort law. It focusses only on those obligations that may be included in the law relating to insolvency and become enforceable once insolvency proceedings commence.

II. Elements of the obligations of directors of enterprise group companies in the period approaching insolvency

A. The nature of the obligations

15. The underlying rationale of imposing obligations on directors in the proximity of insolvency is addressed in the first section of part four, paragraphs 1 to 7, and remains equally applicable in the enterprise group context. The obligations of directors of a group member continue to be the same basic obligations as established in recommendation 255, but provision might be made to permit the broader context of the economic reality of the enterprise group to be taken into account in determining the steps that should be taken by a director to avoid liability for breach of those obligations. Relevant factors to be considered might include the position of the enterprise group member in the enterprise group, the degree of integration between enterprise group members (as mentioned in recommendation 217 of

part three) and the possibility of maximizing value in the group by designing a solution to the group's financial difficulties that includes the whole group or some of its parts. Such solutions may require a director of a group member in financial difficulty to take steps that may appear, at first glance, to be detrimental to that group member, but that will ultimately achieve a better result for it and ensure the continuation of its business and maximization of its value. Taking those same steps in circumstances where they are not likely to benefit the group member in financial difficulty may expose directors to liability for failure to discharge their obligations reasonably.

16. One consideration for directors evaluating the steps to be taken to address the group member's financial difficulties is the impact of those steps on creditors of that group member, especially when wider group interests are to be accommodated. Recommendation 255 requires directors to have due regard to the interests of creditors, as well as of other stakeholders of the group member. The interests of creditors may be safeguarded by establishing a "no worse off" standard — i.e. that creditors will be no worse off under the steps that are taken than they would have been had those steps not been taken.⁶

17. The first section of part four discusses the types of steps that a director might reasonably be expected to take in order to address financial difficulty, avoid the onset of insolvency and, where it is unavoidable, to minimize its impact (see part four, chap. II, para. 5). Those steps would continue to be relevant in the group context and might be supplemented by additional steps, depending on the factual situation, that might effectively require some degree of mutual assistance and cooperation with other group members. Those additional steps might be affected by the position of the group member in the enterprise group and require consideration of whether more value might be preserved or created by assisting the implementation of a solution for the enterprise group as a whole or some of its parts, than by taking steps that relate only to the individual group member. Consideration might be given to assessing the directed member's obligations, both financial and legal, to other group members; the transactions that should (or should not) be entered into with other group members; possible sources and availability of finance [(both in the period approaching insolvency and once formal proceedings commence)],⁷ including its provision by the directed group member to other group members; and the impact of possible solutions, whether limited to the directed group member or involving the group more widely, on creditors and other stakeholders of the directed group member. A director might also consider taking steps to organize informal negotiations with creditors, such as voluntary

⁶ The Working Group may wish to consider whether there is a need for the safeguards provided in this draft text and the draft being developed on cross-border insolvency of enterprise groups to be consistent. See for e.g., draft art. 8, A/CN.9/WG.V/WP.137/Add.1, which refers to adequate protection of creditors in the context of developing a group insolvency solution. See also the purpose clause for recommendations 267-268 and recommendation 267 below.

⁷ The language in parentheses has been added to broaden the issues to be considered beyond the period after proceedings commence (reflected by the current drafting and use of the phrase "post-commencement finance") to include finance that might be required in the period approaching insolvency before the group member commences formal proceedings, as well as once formal proceedings have been applied for and subsequently commenced. This would include both post-application and post-commencement finance, as discussed in the Legislative Guide, part three. The same change is reflected in rec. 268, para. 1(b).

restructuring negotiations, with a view to devising a solution for the enterprise group as a whole or some of its parts where that will benefit the directed group member.

18. Where insolvency is unavoidable and formal proceedings are to be commenced, a director might consider the court in which those proceedings should commence, particularly when there is a possibility of making a joint application with other group members and procedurally coordinating those proceedings, as discussed in part three.⁸

Recommendations 267-268

Purpose of legislative provisions

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 the enterprise group member;

(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 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

(d) To permit an enterprise group member to be managed, where appropriate, in a manner that will maximize value in the enterprise group by promoting approaches to resolve insolvency for the enterprise group as a whole or for some of its parts, whilst taking reasonable steps to ensure that the creditors of that group member and its other stakeholders are no worse off than if that group member had not been managed so as to promote such approaches to resolution.

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

(a) Unnecessarily adversely affect successful business reorganization 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 or some of its parts, 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.

⁸ Legislative Guide, part three, recs. 202-210.

Contents of legislative provisions

The obligations

267. (a) The law relating to insolvency should specify that the obligations established in recommendation 255 will apply to a director of a company that is a member of an enterprise group.

(b) Insofar as not inconsistent with those obligations, the director of an enterprise group member may take reasonable steps to promote a solution that addresses the insolvency of the enterprise group as a whole or some of its parts. In so doing, the director may take into account the possible benefits of maximizing the value of the enterprise group as a whole, whilst taking reasonable steps to ensure that the creditors of the group member and its other stakeholders are no worse off than if that group member had not been managed so as to promote such a solution.

Reasonable steps for the purposes of recommendation 267

268. For the purposes of recommendation[s] 255 and 267, and to the extent not inconsistent with the obligations of the director to the group member of which they are director reasonable steps in the enterprise group context 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 consider whether more value might be preserved or created by considering a solution for the enterprise group as a whole or some of its parts;

(b) Considering the financial and other obligations of the group member to other enterprise group members, whether transactions should be entered into with other enterprise group members, and possible sources and availability of finance, [including when formal proceedings are to be commenced];⁹

(c) 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 or some of its parts;

(d) Assisting the implementation of an insolvency solution for the group as a whole or some of its parts;

(e) Holding and participating in informal negotiations with creditors, such as voluntary restructuring negotiations,¹⁰ where organized for the enterprise group as a whole or some of its parts; and

(f) Where formal insolvency proceedings are to be commenced, considering the court in which they should be commenced, whether a joint application¹¹ with other relevant enterprise group members is possible or appropriate and whether proceedings should be procedurally coordinated.¹²

⁹ See footnote 7 for an explanation of this revision.

¹⁰ Legislative Guide, part one, chap. II, paras. 2-18.

¹¹ *Ibid.*, part three, reccs. 199-201.

¹² *Ibid.*, part three, reccs. 202-210.

B. Identifying the parties who owe the obligations

19. In the enterprise group context, identifying those responsible for management decisions may be more complex than in the case of a single company. Various layers of management and influence can affect the affairs of any single group member and the manner in which it conducts its business, particularly in the vicinity of insolvency. Such influence may undermine the ability of the directors of a group member to take appropriate steps to address the financial difficulties of the directed member or involve that member in the financial difficulties of other group members, to the detriment of the creditors of the directed group member. This may occur in numerous circumstances, such as where the boards of two or more members consist of substantially the same persons; where the majority of the board of one group member is nominated by another group member, which is in a position of control; where one group member controls the management and financial decision-making of the group; or where one group member interferes in a sustained and pervasive manner in the management of another group member, typically in the situation of a parent and controlled group member.

20. There may also be some enterprise groups in which it is difficult to identify the precise boundaries between group members because management responsibilities across different boards are blurred. In addition, relevant executives and decision makers may be employed by group members several steps removed from the group member in question and the separate identity and liability of that group member may be generally disregarded in the daily business of the group. In such situations, serious issues may arise as to the obligations of such persons with respect both to the actual business conducted by the group member in question and to the group member by which they are employed.

21. Persons that might be considered to be a director in the group context could include another group member or the director of another group member, including a shadow director¹³ of that other group member. While some laws do not permit a group member to be formally appointed as a director of another group member, such a group member might nevertheless be regarded as a shadow director of that other member when it exercises influence over or directs its activities.

22. Paragraphs 13 to 16 of the first section of part four discuss the parties who owe the obligations discussed above. Recommendation 258 adopts a broad formulation, providing that it should include any person formally appointed as a director or exercising factual control and performing the functions of a director. Paragraph 15 of the commentary notes the types of function that may be expected to be performed by such a person. Those considerations would also be applicable in the enterprise group context discussed in this part.

C. Conflict of obligations

23. It may often be the case in enterprise groups that a director performs that function or holds a management or executive position in more than one group member, whether as a result of the ownership and control structure of the group, the

¹³ Ibid., part four, footnote 11 to para. 13.

alliances between group members, family ties across the group or some other aspect of the manner in which the business or businesses of the group are organized.¹⁴ Whatever the reason, a director who sits on the boards of, [or has managerial responsibility for,] a number of different group members may face, in the period approaching insolvency, potential conflicts between the obligations owed to those different group members as they attempt to identify the course of action most likely to preserve value and provide the best solution to the financial difficulties of each group member. The nature and complexity of the conflict may relate to the position of the directed entities in the group hierarchy, the related degree of integration between group members, and the incidence of control and ownership. Where a director sits on the boards of the parent and controlled group members, for example, that director needs to be able to demonstrate that any transaction involving the parent took into account, and was fair and reasonable to, the controlled group member.

24. In addition, the interests of the directed group members may be closely intertwined with the enterprise group more widely, requiring the economic reality of the group as a whole to be considered. In such circumstances, steps that may be regarded as detrimental to a company operating as a stand-alone entity may be reasonable when considered in that broader context. The business of a subsidiary, for example, may be generally dependent on the business of the group more widely and it may be appropriate for that subsidiary to provide funding in the short term for other members in order to keep that wider business operating and ultimately save the business of the subsidiary itself.

25. Directors facing such a conflict might be expected to act reasonably and take adequate and appropriate steps to address the situation. That might require a director, depending on the factual situation, to identify the nature and extent of the conflict in accordance with applicable law and determine how it might be addressed. It may be sufficient in some circumstances for the director to disclose relevant information regarding the conflict, including its nature and extent, to the affected boards of directors, while in other circumstances wider disclosure to creditors and other stakeholders, including the boards of directors of other group members, may be reasonable. Such disclosure may be sufficient to support the director's continuing integrity and any lack of the impartiality or independence required can be assessed against the circumstances disclosed.

26. It may be appropriate in some circumstances for the director to refrain from participating in any decisions relating to the conflict that are to be taken by the affected boards or attending meetings at which related issues are to be discussed [and for this to be recorded as a deliberate approach agreed with fellow directors, as opposed to an act of omission.] Appointment of additional or substitute board members may be possible in some cases and, if the conflict cannot be resolved, the director may consider, as a last resort, resigning from one or other of the affected boards. That might potentially include resignation from the board of an insolvent or a solvent group member. While that option of resignation may free the director of the dilemma, it simultaneously neglects the larger problem and may exacerbate the situation, especially in the period approaching insolvency, if it leaves the affected group member or members without the expertise necessary to address their financial

¹⁴ See Legislative Guide, part three, chap. I, paras. 6-15.

difficulties. As noted in the first section of part four, resignation from the board will not 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 or that they had failed to take reasonable steps to minimize losses to creditors in the face of impending insolvency.¹⁵

27. [Good corporate governance that supports analyses of the situations of the respective group members giving rise to the conflict and records the reasons for the action taken may be critical to the director in discharging obligations with respect to the conflict. A policy on corporate governance does not, however, replace or limit obligations owed by directors to the group member or members. It offers indicia as to what steps are considered reasonable to manage the conflict. Different corporate governance policies and standards between the members of an enterprise group can also lead to conflicting solutions and outcomes, which need to be carefully reviewed and assessed by directors.]¹⁶

Recommendations 269-270

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 steps to be taken to discharge those obligations.

Contents of legislative provisions

Conflict of obligations

269. The law relating to insolvency should address the situation where, in the period approaching insolvency, a director of an enterprise group member who holds that position or a management or executive position in another or in other enterprise group members has a conflict between the obligations owed in relation to the creditors and other stakeholders of those different group members.

Reasonable steps for the purposes of recommendation 269

270. The insolvency law may specify that a director faced with such conflicting obligations should take reasonable steps to manage those conflicts. Reasonable steps may include:

- (a) Obtaining advice to establish the nature and extent of the different obligations;
- (b) Identifying the parties to whom the conflict of obligations must be disclosed and disclosing relevant information, including, in particular, the nature and extent of the conflict;

¹⁵ Legislative Guide, part four, chap. II, para. 27.

¹⁶ Revisions to this paragraph seek to address concerns expressed at the forty-seventh session (A/CN.9/835, para. 18) and include some additional suggested text.

(c) Identifying when the director should not (i) participate in any decision by the boards of directors of any of the relevant group members on the matters giving rise to such conflicts, or (ii) be present at any board meeting at which such issues are to be considered;

(d) Seeking the appointment of an additional director when the conflicting obligations cannot be reconciled; and

(e) As a last resort, where there is no alternative course of action available, resigning from the relevant board(s) of directors.
