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## Insolvency Law

### Directors' responsibilities and liabilities in insolvency and pre-insolvency cases

#### Note by the Secretariat

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## Introduction

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

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

3. The subject of this note is the second topic, proposed by the United Kingdom (A/CN.9/WG.V/WP.93/Add.4), INSOL International (A/CN.9/WG.V/WP.93/Add.3) and the International Insolvency Institute (A/CN.9/582/Add.6), concerning the responsibility and liability of directors and officers of an enterprise in insolvency and pre-insolvency cases.<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. This paper draws upon the paper prepared for the Working Group's thirty-ninth session (A/CN.9/WG.V/WP.96), highlights the conclusions reached by the Working Group at its thirty-ninth session (see A/CN.9/715) and raises additional issues for consideration.

## I. The work to be developed

5. Document A/CN.9/WG.V/WP.96, paragraph 15 noted the difficulties associated with harmonizing laws on directors' responsibilities and liabilities in the insolvency context. The Working Group acknowledged those difficulties and identified the need, in considering this topic, to avoid interfering with company and other civil law or criminal law (A/CN.9/715, para. 66). Nevertheless, it agreed that providing guidance on the topic would be appropriate (A/CN.9/715, para. 67). The aim would be to ensure that where insolvency was approaching, directors would have the incentives needed to take appropriate and timely action to preserve the value of the company, rather than simply waiting for commencement of insolvency proceedings. Those incentives would be balanced with consequences, such as personal liability, where such action was not taken.

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<sup>1</sup> The first topic, concerning centre of main interests and related issues is discussed in A/CN.9/WG.V/WP.95 and Add.1 and A/CN.9/WG.V/WP.99.

6. The proposals that A/CN.9/WG.V/WP.96 responded to suggest that it should be possible to crystallize, from effective insolvency regimes, basic principles or guidelines to be reflected in officer and director duties in insolvency. The Working Group noted (A/CN.9/715, para. 62) that the type of guidance to be provided would need to be descriptive rather than normative or prescriptive and that expressions of principle would avoid interference with issues of corporate law.

7. Issues to be discussed might include: the form any principles or guidelines might take and the topics those principles or guidelines might address.

## **A. Form of possible principles or guidelines**

8. In considering the form those principles or guidelines might take, the Working Group may wish to recall the approach adopted in the UNCITRAL Legislative Guide on Insolvency Law (the Legislative Guide) of discussing many of the issues relevant to the development of an effective and efficient insolvency regime in some detail in the commentary and then deriving, as appropriate, a set of legislative recommendations on the key points. Not all issues discussed in the commentary are addressed in the recommendations. At a general level, a commentary on directors' duties could provide guidance to States on the circumstances that could lead to personal director liability, at the same time recognizing the pitfalls and threats to entrepreneurship that may result from overly draconian rules. As noted by the Working Group (A/CN.9/715, para. 108), a key element would be the need to strike a balance between promoting appropriate behaviour and avoiding premature insolvency.

9. As to the scope of the principles or guidelines themselves, the Working Group may wish to recall the variety of approaches adopted in the Legislative Guide, i.e. recommendations that, at their most basic, point to a topic to be addressed in insolvency law and, at their more specific, set forth the detailed manner in which the insolvency law should address the particular issue. The principles or guidelines on directors' duties might adopt the former, more general approach, stating the issue to be addressed and the general manner in which it might be approached including, as appropriate, alternatives. An accompanying commentary could provide, in much the same manner as the Legislative Guide, background and more detailed information on the particular issue.

10. Such an approach would be similar to the approach taken by the OECD Principles, as noted in paragraph 15 of A/CN.9/WG.V/WP.96, which might provide a working basis for the development of this topic:

“There is no single model of good corporate governance. However, work carried out [...] has identified some common elements that underlie good corporate governance. The Principles build on these common elements and are formulated to embrace the different models that exist.

“The Principles are non-binding and do not aim at detailed prescriptions for national legislation. Rather, they seek to identify objectives and suggest various means for achieving them. Their purpose is to serve as a reference point. They can be used by policy makers as they examine and develop the legal and regulatory frameworks for corporate governance that reflect their

own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices.”<sup>2</sup>

## **B. Issues to be addressed**

11. The principles or guidelines might address the following issues:
- (a) Identifying who owes the duties;
  - (b) Defining the time at which the duties arise;
  - (c) Identifying the persons to whom the duties are owed;
  - (d) The nature of the duties or the types of misconduct to be covered;
  - (e) Identifying the remedies available;
  - (f) Cross-border issues.

## **II. Identifying who owes the duties**

12. The Working Group agreed that, as a starting point, it would be appropriate to include formally appointed directors, whether natural or legal persons. As to additional persons, such as de facto or shadow directors and various other persons in a position of influence (a number of possibilities were identified), it was agreed it might be more appropriate to adopt a purposive approach, rather than using terms such as “de facto” or “shadow directors” (A/CN.9/715, para. 69). The Working Group agreed that the question of whether the group of persons should be expanded beyond directors to others with influence needed to be considered further (A/CN.9/715, para. 72).

### **A. Formally appointed directors as the starting point**

13. In view of the above, the starting point of any principles or guidelines on this issue could be that the duties are owed by formally appointed directors, whether natural or legal persons. The principles might provide a general statement to that effect or, as an alternative, an approach similar to that followed by the OECD Principles, that the duties are owed by the formally appointed members of whatever body is charged with the functions of governing the enterprise and monitoring management. Should it be necessary to give examples of those functions, reference might be made to other texts, such as the OECD Principles, in which they are further described.

### **B. Additional persons**

14. The Working Group may wish to consider the question of whether or not additional persons should be included within the scope of any principles on the basis of the discussion set forth in paragraphs 19-23 of A/CN.9/WG.V/WP.96 and

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<sup>2</sup> OECD Principles, p. 13.

the discussion at the thirty-ninth session (A/CN.9/715, paras. 69-71). The issue might be approached, for example, by indicating in commentary rather than a statement of principle the other types of person who might also owe such duties drawing, for example, on paragraphs 19-21 of A/CN.9/WG.V/WP.96.

### **III. Defining the time at which the duties arise**

15. The Working Group agreed that the duties would arise when the debtor was or would imminently become insolvent, referred to as the “vicinity of insolvency”, although they could only be enforced once insolvency proceedings had commenced. It was noted that the point at which the duties arose should be the point at which directors should have been aware there was no reasonable prospect of avoiding insolvency (A/CN.9/715, para. 81).

16. Since the Working Group’s agreement recognizes the duties could arise before the commencement of insolvency proceedings, there is a need to define what constitutes the requisite point at which they arise, possibly by reference to the requisite state of “insolvency”. The Legislative Guide e.g., part two, chap. I, paragraphs 23-30 and recommendations 15 and 16, which address the standards required to be met for commencement of insolvency proceedings, including imminent insolvency, might provide a starting point for further discussion (see also A/CN.9/WG.V/WP.96, paras. 49-53).

### **IV. Identifying to whom the duties are owed**

17. The Working Group raised a number of issues, including the relevance of the time at which the duty was to be considered (e.g. at the onset of insolvency or after commencement of insolvency proceedings); whether the duty would be owed to the general body of creditors or the insolvency estate per se (an approach said to be consistent with the Legislative Guide and one that would involve a practical approach based on identifying the potential beneficiaries of any recovery action); and how the issue would be addressed in the context of enterprise groups.

18. The decision noted above in III with respect to the time at which the duty arises suggests that the persons to whom the duty is owed might extend beyond the insolvency estate per se, since that would only be formed on commencement of insolvency proceedings. Nevertheless, if the duties can only be enforced post-commencement, the insolvency estate might be the relevant beneficiary and the insolvency representative the person most likely to enforce those duties. The various options were discussed in A/CN.9/WG.V/WP.96, paragraph 33.

19. The Working Group agreed to continue its deliberations at a future session based on the discussion at its thirty-ninth session (A/CN.9/715, paras. 73-79).

### **V. The nature of the duties or the types of misconduct to be covered**

20. The Working Group agreed to base its future deliberations on identifying the steps that would need to be taken to discharge a duty of wrongful trading

(A/CN.9/715, para. 91). An introduction to wrongful trading legislation is provided in A/CN.9/WG.V/WP.96, paragraphs 58-60.

## **VI. Identifying the remedies available**

21. It was generally agreed that the insolvency representative would normally have the right to enforce the relevant duty (A/CN.9/715, para. 97); and that insolvency provisions should not negate the rights of others to pursue such a breach where those rights arose under other bodies of law (civil, company or tort law) (A/CN.9/715, para. 98).

22. The Working Group may wish to consider whether, given its conclusion with respect to the time of enforcement of the duties and concerning the rights of others to pursue such a breach, any guidance to be provided should address which other parties might have a right to pursue a breach in the event, for e.g., that the insolvency representative failed to do so. It may also wish to consider whether such guidance should address issues such as the payment of costs where the insolvency representative does pursue such an action, but is unsuccessful.

## **VII. Cross-border issues**

23. The Working Group agreed to consider a number of issues raised (applicable law, access to a foreign jurisdiction to pursue liability actions, applicability of defences from one jurisdiction to proceedings in another) at a future session (A/CN.9/715, para. 109).

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