United Nations A/CN.9/WG.V/WP.96

General Assembly

Distr.: Limited
27 August 2010

Original: English

United Nations Commission on International Trade Law
Working Group V (Insolvency Law)
Thirty-ninth session
Vienna, 6-10 December 2010

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.[1] In the light of concerns raised during extensive discussion, the Commission agreed that the focus of the work on that topic should only be upon those responsibilities and liabilities that arose in the context of insolvency, and that it was not intended to cover areas of criminal liability or to deal with core areas of company law.

4. The benefits of effective insolvency laws are widely recognized and accepted by most nations, as evidenced by the UNCITRAL Legislative Guide on Insolvency Law (the Legislative Guide) and the efforts of many nations in recent years to update their insolvency laws to take into account modern finance and business. In addition to providing a predictable legal process for addressing the financial difficulties of troubled firms and the necessary framework for the efficient restructuring or orderly liquidation of those firms, effective insolvency laws also permit an examination to be made of the circumstances giving rise to insolvency and in particular the conduct of directors and officers of a company, perhaps revealing inappropriate behaviour on the part of those responsible for that failure, including unfair dispositions of assets or property that are potentially recoverable. Inefficient, antiquated and inconsistent guidelines on director and officer obligations as a company approaches insolvency have the potential to undermine the benefits that the Legislative Guide is intended to produce.

5. The importance of commencing proceedings at an early stage cannot be overestimated. Financial decline typically occurs more rapidly than many parties would believe and as the financial position of an enterprise worsens, the options available for a viable restructuring also rapidly diminish. While there has been an appropriate refocusing of insolvency laws in many countries to increase the options for restructuring and rescue of enterprises, there has been little focus on creating

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

appropriate incentives for directors and officers to use those various options. Far too often, it is left to creditors to commence those proceedings because the directors have failed to act on a timely basis. Notwithstanding that many insolvency laws purport to impose an obligation on directors to commence insolvency proceedings within a certain period of the commencement of insolvency, those obligations are rarely enforced. This is frequently because it is necessary to prove that the directors' actions were fraudulent.

6. For that reason, some jurisdictions have replaced the "fraudulent trading" tests with a "wrongful trading" test, which provides that directors may be liable if they continue trading beyond the point where they knew or should have known that the company would be unable to avoid insolvent liquidation.

7. In addition to encouraging the earlier commencement of insolvency proceedings, effective provisions for the roles and duties of directors and officers would promote good corporate governance. A clear view of the liabilities of directors and officers could also lead to a more predictable legal position for those directors and limit the risks that insolvency practitioners will litigate against them. The more clearly the responsibilities are defined, the more predictable the legal position will be. In addition, it may encourage the more experienced managers, who may be reluctant to participate in management due to the risks related to failure, to do so.

I. Features of possible work

A. Background

8. Officer and director duties and liabilities are specified in different laws in different States, including company law, civil law and insolvency law. In some States, they may be included in more than one of those laws. In some jurisdictions, for example, director duties in insolvency and the vicinity of insolvency are regarded as a matter only for either insolvency or company law; other jurisdictions include relevant provisions in both laws. Those laws are typically reinforced by complementary elements of tort law or criminal law (not the subject of this paper). In common law systems, they may apply by virtue of common law, as well as pursuant to relevant legislation.

9. The application of laws addressing officer and director duties 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.

10. Companies facing insolvency need robust management, as often there are difficult decisions and judgements to be made. Directors afraid of the possible financial repercussions of making such business decisions may prematurely close down a company rather than seek to trade out of difficulties. Accordingly, effective regulation in this area should seek to balance these often competing goals and the interests of different stakeholders: seeking to preserve the freedom of directors and

officers to undertake their duties and exercise their judgement appropriately, while at the same time encouraging responsible behaviour, discouraging unreasonable risk-taking, promoting entrepreneurial activity, and encouraging, at an early stage, the refinancing or restructuring of companies facing insolvency.

11. While much has been done by the Organisation for Economic Co-operation and Development (OECD) to develop widely adopted principles of corporate governance that include the duties of directors of companies[2] outside of insolvency (see below, para. 29), little has been done internationally in the context of insolvency to harmonize the various approaches of national law.

12. Experience in the European Union highlights some of the difficulties. In 2002, a High Level Group of Company Law Experts (the Expert Group) established by the European Commission recommended that a rule on wrongful trading should be introduced at European Union (EU) level. The rule would hold company directors (including shadow directors) accountable for letting the company continue to do business when it should be foreseen that it would not be able to pay its debts.[3] The Expert Group noted that national rules varied considerably. In some Member States there were no specific provisions, but a similar effect was achieved through general rules on directors' liability, sometimes by tort law. Where there was a general duty to apply for commencement of insolvency proceedings in the case of actual insolvency, it usually applied too late to be effective. The Expert Group suggested that the recommended rule would not interfere with the ongoing business decisions of directors, as long as an insolvency situation was not yet foreseeable. The rule would enhance both creditors' confidence and their willingness to do business with companies, as well as introduce an equivalent level of protection for creditors of companies across the EU. It would also avoid the need to harmonize the whole body of directors' liability rules in all Member States, an activity that was likely to prove extremely difficult. One of the issues at stake was whether such a rule was properly part of company law or insolvency law. The Expert Group took the view that the issue of whether directors should be responsible was at its most important prior to insolvency and was thus a key element of a corporate governance scheme, rather than of an insolvency regime. The European Commission subsequently supported the proposals for a wrongful trading rule and director disqualification.[4]

13. In 2006, however, the majority of respondents to a public consultation on future priorities for the 2003 Action Plan on the Modernisation of Company Law and Corporate Governance (which included the development of provisions on director responsibility), opposed the development of such harmonized provisions, based on the existing detail of national regulations.[5] Common EU rules, it was suggested, would lead to legal uncertainty as a result of the overlap with national

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2 OECD Principles of Corporate Governance, 2004, section VI (the OECD Principles).

3 Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels 4 November 2002. The Group was established by the European Commission in 2001 (the Expert Group report), chapter 3, section 4, pp. 68-69.

4 Communication from the Commission to the Council and the European Parliament: Modernising Company Law and Enhancing Corporate Governance in the European Union — A Plan to Move Forward, Brussels, 21 May 2003 COM (2003) 284 final, section 3.1.3.

5 Directorate General for Internal Markets and Services, Consultation and hearing on future priorities on the action plan for modernising company law and enhancing corporate governance in the European Union, 2006 (the 2006 EU Report).

regulations and the benefits of harmonization were outweighed by the potential costs and difficulties associated with it. Moreover, since the issue was closely related to private law, especially insolvency law, criminal law and procedural law, some respondents argued that it could not be dealt with at EU level in a pure company law context.

14. Notwithstanding the difficulties identified by the public consultation, the proposals that this note responds to suggest that it should be possible to crystallize, from effective insolvency regimes, basic principles to be reflected in officer and director duties in insolvency. Those principles could outline the particular features that best give effect to the public and international policy objectives sought to be achieved through those regimes and provide guidance to States on the circumstances that could lead to personal director liability. At the same time, they should recognize the pitfalls and threats to entrepreneurship that may result from overly draconian rules.

15. The preamble to the OECD Principles suggests an alternative to harmonization of national laws that might be considered by the Working Group in discussing the issues outlined below:

> "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."[6]

B. Issues to be considered

16. This note outlines a number of related issues that might be considered in developing guidelines or principles on the duties and liabilities of directors in the context of insolvency, including:

(a) Identifying who may be considered a director or officer of a company for the purposes of deciding who should owe the various duties, including formally appointed directors and others;

(b) The nature of the duties of directors and the persons to whom they are owed outside of insolvency;

(c) Whether the nature of the duties and the persons to whom they are owed changes in the vicinity of insolvency and the time at which that change occurs;

(d) Breach of duty and the nature of the liability for breach, the focus of this note being upon civil, rather than criminal, liability;

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[6] OECD Principles, p. 13.

(e) Defences available for breach of duty;

(f) Enforcement of a breach of duty, including the party that may pursue a breach and possible consequences of breach, including fines, payment of damages and director disqualification.

17. Different States adopted different approaches to these issues. The discussion below provides a broad indication of some of those different approaches to facilitate discussion by the Working Group, but it is necessarily selective.

II. Before the onset of financial difficulty or insolvency

A. Duties with respect to management and oversight of a company

1. Identifying who owes the duties: persons that may be considered a "director"

18. In most States, a number of different persons associated with a company have duties with respect to management and oversight of the company's operations. They may be owners of a company, formally appointed directors, officers or managers (who may serve as executive directors) and non-appointed individuals and entities, including third parties acting as de facto or "shadow" directors.

19. A de facto director is generally considered to be a person who acts as a director, but is not formally appointed as such. 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 factor 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.

20. 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, 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.

21. For ease of reference, these different categories of directors are referred to in this note as "directors".

22. The OECD notes that notwithstanding the varieties of structures used for boards of directors of companies,[7] the Principles are intended to apply to whatever

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[7] Some countries have two-tier boards that separate supervisory and management functions, where the supervisory board is composed of non-executive members (generally, neither managers nor owners of the business) and the management board of executive members

body is charged with the functions of governing the enterprise and monitoring management, with members of the board having specific duties in that regard.

2. Functions of directors

23. The OECD Principles indicate the functions typically carried out by boards of directors. They include: reviewing and guiding corporate strategy, risk policy, annual budgets and business plans, setting performance objectives, 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; accounting to the stakeholders for the organization's performance; and overseeing disclosure and communication.[8]

B. The nature of the duties

24. The national laws or policies of many States include some reference to standards or duties for directors in the performance of their functions. Laws generally impose duties on directors in carrying out those functions on the basis that although they manage and exercise control over a company, the company is (in theory) run for the benefit of the shareholders. The role and responsibilities of directors may vary with the nature and type of the business entity e.g., a public company as opposed to a limited, closely held or private company or family business, and with the jurisdiction in which the entity operates. For public companies, the duties are typically much more rigorous and complex than for other types of companies. Generally, the duties will apply to each director separately, rather than to the board as a whole.

25. The duties imposed on directors in carrying out their functions are fiduciary in nature, similar to those that the law imposes on others in positions of trust, such as agents and trustees. Two key elements of the fiduciary duty are, typically, a duty of care and a duty of loyalty, although in some States the only fiduciary duty is said to be that of loyalty.

26. The duty of care generally requires directors to act on a fully informed basis, honestly and in good faith. In some jurisdictions, the requirements of honesty and good faith form part of the duty of loyalty. Under some laws, these duties require directors to act in the best interests of the company and, in so doing, to exercise due diligence or the diligence expected of a responsible or a good business person. In many States, the duty of care does not extend to errors of business judgement provided, for example, directors are not grossly negligent and the decision was made with due diligence.[9] In some States, the business judgement rule establishes a presumption that in making a business decision, the directors of a company acted on

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(officers or managers of the business). Other countries have unitary boards, which include both executive and non-executive members. Some countries may also have an additional statutory body for audit purposes: Annotations to the OECD Principles, section VI, The Responsibilities of the Board, p. 58.

[8] Id., VI.B, p. 60.

[9] Id., VI.A, p. 59.

an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.[10] Such a rule can be rebutted by showing a breach of the duty of care or good faith.

27. The OECD Principles note that the duty of loyalty underlies observation or performance of many of the functions noted above (para. 23) and is key in the enterprise group context, since it requires a director to observe or perform those functions in relation to the company to which he or she is appointed, not in relation to the controlling member of the group.[11]

28. In some States,[12] the duties are set out in some detail in legislation and include, for example, in addition to a duty to act in the company's best interests, duties to obey the company's constitution and decisions taken under it; to be honest and remember that the company's property belongs to it and not to the director or to its shareholders; to be diligent, careful and well-informed about the company's affairs; to ensure the company keeps records of directors' decisions; and to avoid conflict of interest situations. More specific duties that States[13] impose on directors include duties to file a report on his or her performance once every three months; to report to the auditor or the auditing committee where a director becomes aware of any indication of a significant loss to the company; and to monitor the performance of other directors.

29. The OECD Principles, section VI, address the duties of directors:

(a) To act on a fully informed basis, in good faith, with due diligence and care, and in the best interests of the company and the shareholders;

(b) To treat all shareholders fairly, especially where board decisions may affect different shareholder groups differently;

(c) To apply high ethical standards, taking into account the interests of stakeholders;

(d) To fulfil key functions (such as those noted above in para. 23);

(e) To exercise objective and independent judgement on company affairs; and

(f) To ensure that they obtain accurate, relevant and timely information.

30. What amounts to the best interests of the company may vary from State to State. In one State, for example, it has been interpreted as distinct from the best interests of shareholders or creditors and means, from the economic perspective, maximizing the value of the company. In determining what amounts to the best

[10] Such a rule applies in the United States and a number of other jurisdictions. Variations of the business judgement rule have been developed. For example, the modified business judgement rule or the proportionality test, which requires directors to demonstrate that any action taken was reasonable in relation to the threat posed (Unocal v. Mesa Petroleum, 493 A.2d 946 (Del. 1985)). It was later modified to require a determination of whether the director's defensive measure had the effect of coercing shareholders choice, followed by application of the proportionality test (Unitrin, Inc. v. American General Corp 493 A.2d 946 (Del. 1985)).

[11] Annotations to the OECD Principles, section VI.A, p. 59.

[12] For example, England: Companies Act, 2006.

[13] For example, Korea.

interests of the company, directors may have regard to various factors, given the circumstances of the case, including the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.[14]

31. Further work undertaken on corporate governance by the OECD in the context of the financial crisis, suggests that one way in principle to improve board performance is to clearly define their duties and then to allow or encourage enforcement by shareholders and/or regulators. It notes that the standards set forth in paragraphs (a) and (c) of paragraph 29 above, taken together, set strict normative standards for directors and reflect the legal position in a number of jurisdictions. The work also indicates that the Principles advocate long run wealth maximization and not simply "shareholder value".[15]

32. Much has been written on the interpretation of the above duties in different States. It is beyond the scope of this paper to provide a detailed analysis of those different interpretations. The Working Group may wish to consider whether such an analysis would assist its future deliberations.

C. Persons to whom the duties are owed

33. Laws vary as to the persons to whom the directors' duties are owed when a company is solvent, some distinguishing, for that purpose, between the duty of care and the duty of loyalty. Typically, the duties are owed to the company itself, which in some States may be interpreted as including both shareholders and creditors of the company. In some States, they may also be owed to the shareholders, which may be interpreted as meaning a duty to shareholders generally, and not a duty to individual shareholders. Where a distinction is made in terms of focus, the duty of loyalty is owed only to the company, while the duty of care may also be owed to creditors and other stakeholders. Directors may be expected to have due regard to, and deal fairly with, the interests of those stakeholders, such as employees, customers, suppliers and local communities. The latter might involve, for example observance of environmental and social standards. As the OECD notes, the duties of boards are quite complex and may involve achieving a balance between constituencies that often have widely diverging views.[16]

III. The onset of financial difficulties or insolvency

34. The following discussion is limited to a consideration of the duties of directors when the company is in a situation of financial distress or insolvency.

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[14] Canada, *Peoples Department Stores Inc. v Wise* 2004 SCC 68, para. 41-42, see J. Sarra, Canada's Supreme Court Rules on Fiduciary Obligation Towards Creditors on Insolvency — Peoples Department Stores v Wise, *Int. Insolv. Rev*. Vol 15: 1-15 (2006).

[15] Corporate governance and the financial crisis: conclusions and emerging good practice to enhance implementation of the principles, Directorate for Financial and Enterprise Affairs, OECD Steering Committee on Corporate Governance, 24 February 2010, para. 62.

[16] Id., para. 63.

A. Duties arising on commencement of insolvency proceedings

35. Many insolvency laws recognize that when insolvency proceedings commence the focus is upon maximizing value and preserving the estate for distribution to creditors. The duties of the directors and officers will thus differ both in substance and focus from those applicable when the company was solvent. Often they 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. The Legislative Guide, for example, addresses those duties in recommendations 108-114 and in the commentary, paragraphs 22-34. Recommendation 110 specifies in some detail the duties that should arise under the insolvency law on commencement of insolvency proceedings and continue throughout those proceedings, including duties 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.

36. Recommendation 114 and paragraph 34 of the commentary address the imposition of sanctions where the debtor fails to comply with those duties. In some systems, directors and officers may be criminally liable for failure to observe those duties, in others they may be personally liable for any damage caused as a result of the breach of those duties.

B. Duties arising on insolvency and in the period approaching insolvency

37. An issue that is increasingly receiving attention, but where there are significant divergences in approach, is whether the duties of directors of a company should be affected at some point before an application for or commencement of insolvency proceedings, variously described as the "twilight zone", the "zone of insolvency" or the "vicinity of insolvency". Although a somewhat nebulous concept, it is intended to convey a deterioration of the company's financial stability which, if it remains unaddressed, is likely to lead to insolvency and commencement of insolvency proceedings. If the duties should be affected in that period, there is a related question of the time at which that should occur and how the requisite state of "insolvency" would be defined. Also relevant is the nature of the directors' duties at that time and whether they differ from the duties applicable when a company is solvent.

1. Should directors have a duty to creditors in the vicinity of insolvency?

38. In one State, it has been confirmed that directors owe no fiduciary duty to creditors at the point of, or in the vicinity of, insolvency, where the fiduciary duty in question is the duty of loyalty to the company (i.e. to act honestly and in good faith with a view to the best interests of the company). The content of that duty does not change with the financial health of the company and is, at all times, a duty to the

company. The interests of the company are not to be confused with the interests of creditors or of other stakeholders.[17] A key reason for there being no change in the focus of directors' duties at that time is the availability of a remedy which provides that where directors of a company have used their powers "in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer"[18] those interested parties may be entitled to gain relief from the company's conduct. This remedy is based on the notion that companies have a responsibility to act as good corporate citizens and therefore must take into account the interests of all stakeholders who may be affected by the company's actions. The focus is on behaviour that can be described as corporate behaviour and not personal or non-business related conduct. Relevant conduct may be conduct that is coercive, abusive, burdensome, harsh, in bad faith, an abuse of power, or involves some other kind of serious wrong.

39. The World Bank "Principles for Effective Insolvency and Creditor Rights Systems" recommend that "laws governing director and officer liability for decisions detrimental to creditors made when an enterprise is in financial distress or insolvent should promote responsible corporate behaviour while fostering reasonable risk taking. At a minimum, standards should hold management accountable for harm to creditors resulting from wilful, reckless, or grossly negligent conduct."[19]

40. A number of commentators oppose the notion of directors having a duty to creditors before the commencement of insolvency proceedings on the basis that creditors are adequately protected by other provisions of the law, such as those dealing with fraudulent transfers, and can manage any risk through, for example, contracts and insurance.

41. A different approach is based on the analysis that imposing a duty to creditors acts as a counter incentive for directors to maximize their own position as shareholders by seeking to trade out of insolvency. Such a course of action may involve adopting high-risk strategies to save or increase value for shareholders, at the same time putting creditor's interests at risk, and may reflect limited concern for chances of success because of the protection of limited liability if the course of action adopted fails. Once insolvency occurs, the shareholders no longer have anything of value and are replaced by creditors as the residual claimants. Accordingly, the analysis goes, directors' fiduciary duties should then shift to creditors, instead of focusing on maximizing value for shareholders.

42. In some States, it is said that officers' and directors' duties *change* in the period approaching insolvency to protecting the creditors of the company, rather than the shareholders; in others, the notion is that they *expand* to include creditors, in addition to the shareholders. The duty to protect the interests of the company generally remains constant

43. While the underlying rationale for imposing on directors a duty to creditors in the event of insolvency may be the same in different jurisdictions, different

[17] Canada: *Peoples Department Stores Inc. v Wise* 2004 SCC 68, para. 43.

[18] Canadian Business Corporations Act 1985, section 241(2)(c).

[19] World Bank "Principles for Effective Insolvency and Creditor Rights Systems", 2005, Part B: Risk Management and Corporate Workout, B2: Director and Officer Accountability.

approaches are taken to formulating the duty and determining the standard to be met. One approach is based on a trust doctrine, which treats directors as trustees of the company's assets to be held for the benefit of creditors when the company is insolvent and imposes a duty to protect those assets for the creditors.

44. A different approach suggests that when directors know the company cannot meet its obligations as they fall due, they should be required to take action to monitor the financial situation of the company and avoid insolvency. If they nonetheless continue to carry on business that involves, for example, obtaining goods and services on credit, without disclosing the financial situation to those creditors, they should incur personal liability.

45. An INSOL study on this topic points to the various advantages and disadvantages of imposing personal liability on directors and officers for a company becoming insolvent.[20] The advantages include:

(a) Early stoppage to 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;

(b) Controlling and disciplining management by the imposition of tough sanctions; and

(c) Providing an incentive to management to obtain competent professional advice when financial difficulties loom.

46. The disadvantages include:

(a) The possibility of a premature closure of viable businesses which could have survived;

(b) Inhibition of the pursuit of voluntary restructuring because directors are unwilling to trade out of difficulties;

(c) Erosion of the legal status brought by incorporation and weakening of enterprise incentives. Too much risk may discourage directors and even if director insurance can be paid by the company, the cover is expensive and is often subject to wide exceptions;

(d) Unpredictability, because liability depends on particular circumstances and also the future attitudes of the courts; and

(e) An increased risk of unexpected liabilities for banks and others who might be deemed to be de facto directors by reason of their involvement in the company, particularly at the time of the insolvency.

47. As noted above, some commentators suggest that a duty to creditors should be regarded as additional to a duty to shareholders. In such a case, directors may be faced with potential conflicts. As an example, a company's financial situation might indicate that it will have to apply for commencement of insolvency in several weeks time, in which case shareholders would have no remaining interest and creditors would not have their claims paid in full. Creditors would be likely to support a sale of the business for a purchase price covering the debt in full, but shareholders may

[20] Directors in the Twilight Zone III (2009), INSOL International, Overview, p. 5.

want to hold out for a higher price or a different purchaser in the hope of some return, however minimal.[21] Directors would be faced with choosing the course of action that best served the interests of the company as a whole, having weighed the interests of the different stakeholders in the circumstances of the specific case.

48. The extent to which personal liability of directors provides significant protection for creditors varies with the circumstances. For example, directors of smaller firms are often principals, who are likely to lose their personal and business assets at the same time, leaving little to satisfy creditor claims. Large firms, however, frequently purchase liability insurance for their directors, which may compensate injured creditors, but at the same time protect directors, undercutting incentives to satisfy specified duties of care and other standards of behaviour. However, the number of spectacular company failures in some jurisdictions in recent years may have had a negative effect on director and officer liability insurance, making it increasingly expensive and risky. In addition to these considerations, the protection afforded to creditors may be affected by their ability to pursue a breach of the duty and, if directors are found liable, the consequences in terms of recovery or damages; it has been suggested that recovery for the benefit of the insolvency estate is potentially more of a benefit to secured than to unsecured creditors.[22] As the OECD Principles note, enforcement possibilities are weak in many jurisdictions due in part to poor powers of discovery and high costs,[23] a fact emphasized by many other commentators.

2. Determining commencement of the "vicinity of insolvency"

49. If directors were to have a duty to creditors in the vicinity of insolvency, there are various possibilities for determining the time at which that duty might arise.

50. One possibility may be the point at which an application for commencement of insolvency proceedings is made, arguably the possibility that creates 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 of the Legislative Guide), this option will have little effect.

51. Other possibilities focus on the duty arising when a company is in fact or technically insolvent, which 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 exceeds the value of its assets. A further possibility is when insolvency is imminent, i.e. where the company will generally be unable to pay its debts as they mature (see recommendation 15 of the Legislative Guide). These tests are increasingly used in insolvency laws as commencement standards and in some States are used as the basis for imposing an obligation on directors to apply for

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[21] R. de R. Barondes et al, Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies, 1 *J. Bus & Tech L* (2006-2007), 229 at 233.

[22] J. Payne and D. Prentice, Civil Liability of Directors for Company Debts under English Law, chap. 8, pp. 193-194, in I. Ramsay, ed., Company Directors' Liability for Insolvent Trading, University of Melbourne, 2000.

[23] OECD Corporate governance and the financial crisis, see note 15, para. 63.

commencement of insolvency proceedings within a specified period of time, usually rather short, after a company becomes insolvent.

52. Some courts have tried to define what the "vicinity of insolvency" might mean. In one case, the court suggested that it occurred when the company could not "generate and/or obtain enough cash to pay for its projected obligations and fund its business requirements for working capital and capital expenditures with a reasonable cushion to cover the variability of its business needs over time."[24] The court took the view that by the time the company could not pay its current debts, it would be too late to protect creditors. The period of heightened duty in that case was extended to four years before the actual crisis without regard to the foreseeability of a loss of liquidity. That length of period is reflected in the laws of other States, which allow directors to be held liable for performance of their duties in an improper manner for up to three years before the company became insolvent.

53. A different approach to devising a definition focuses on the point at which a director or officer knew, or ought to have known, that the company was insolvent or was likely to become insolvent or that there was no reasonable prospect that the company could avoid having to commence insolvency proceedings. Both of those tests are subjective and require wider consideration of circumstances and context, including, for example, examining the books of the company and its financial condition. One concern with that type of standard might be the difficulty of determining with certainty the exact point at which the director could be said to have contributed to the company's insolvency.

3. The nature of the duty

54. Many insolvency or company laws include provisions addressing responsibility of directors in the period before insolvency proceedings commence, although approaches differ widely. Some impose liability for causing insolvency, while others focus more closely on the breach of specific duties, such as the duty of loyalty, the duty to enhance the interests of the company and the duty to act solely for the financial benefit of the creditors. Under some laws, the duty owed in the vicinity of insolvency adds to the duties owed by the directors when the company is solvent, requiring them to take certain steps to avoid or ameliorate financial difficulty and minimize potential losses to creditors. In some jurisdictions, the duty of care and the applicable standard may vary among different members of the board.[25]

55. Under some laws,[26] directors have an obligation to exercise the diligence expected of a responsible businessman that also includes a duty, if a crisis threatens, to consider all possible remedial steps, and as far as possible, to initiate appropriate measures. Those steps might include calling a shareholders' meeting if it appears to be in the best interests of the company and without undue delay, if it appears from the balance sheet that half or more of the share capital has been eroded (generally applicable where the law includes capital maintenance requirements). Directors may also have a duty to apply for commencement of insolvency proceedings, which would include reorganization or liquidation, within a specified period of time,

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[24] USA: *Pereira v Cogan*, 294 B.R. 449, (S.D.N.Y. 2003).

[25] For example, Switzerland.

[26] For example, Germany and a number of other civil law jurisdictions.

usually fairly short such as three weeks, after the date on which the company became 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.

56. Under other laws, certain actions of directors, once a company is insolvent, may be rendered unlawful under, for example, wrongful or fraudulent trading provisions,[27] or as acts having worsened the economic situation of the company or having led to insolvency. The concept of wrongful trading may apply both to directors of independent companies and to directors of enterprise group members. The directors of an enterprise group member might be subject to the rules if they operated, as noted above, as de facto or "shadow" directors of another group member.

4. The standard to be met

57. As with the description of the duty, the behaviour of directors is judged against different standards to determine whether or not they have failed to meet their obligations.

58. Wrongful trading legislation, as noted above (see above, paras. 6, 12 and 56), typically focuses on the point at which a director or officer knew, or ought to have known, that the company was insolvent or was likely to become insolvent. The director may be judged in that regard 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. That type of test is subjective and more may be expected of a director of a large company with sophisticated accounting systems and procedures. Similarly, if the director's skills and experience exceed those required for the job, the judgement may be made against the skills and experience possessed, instead of against those required for the job. On the other hand, 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.[28]

59. Another approach[29] requires that there be reasonable grounds for suspecting the company was insolvent or would become insolvent at the time of incurring the debt leading to insolvency. The suspicion must involve a positive feeling of actual fear or misgiving amounting to an opinion which is not supported by sufficient evidence. This is a lower threshold than expecting or knowing the company is insolvent. The standard is that of the awareness of a reasonable person in a like position in a company in the company's circumstances.[30]

60. A further approach, focusing on mismanagement, judges the director against the standards of a normally well-advised director. Examples of behaviour or actions that might give rise to liability include imprudence, incompetence, lack of attention, failure to act, engaging in transactions that were not at arm's length or of a

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[27] For example, England (Insolvency Act 1986) and Ghana.

[28] G. Siegel, and P. Rosen, Are United States Courts developing a United Kingdom approach to the liability of directors of insolvent companies?, April, 2004, p. 3, quoting T. E. Cooke and A. Hicks, Wrongful Trading — Predicting Insolvency, *J.B.L.* (1993), 338 at 338-339.

[29] For example, Australia: Corporations Act 2001, S588G.

[30] See H. H. Rajak, Director and Officer Liability in the Zone of Insolvency: a Comparative Analysis, PER 2008(1), p. 23.

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 the company's financial capacity and which were not in its best interests.[31] Other examples that also focus on 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 the 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.[32]

61. A number of jurisdictions, rather than considering the actions of directors before, or in the vicinity of, insolvency, focus on remedying transactions and other actions that took place before the commencement of insolvency proceedings through the use of avoidance powers once insolvency proceedings commence. Permitting a company to enter into such a transaction may support a finding of liability under, for example, wrongful trading laws.

5. Defences

62. Under some laws, where directors do have a duty to creditors in the vicinity of insolvency, they may nevertheless rely on certain defences, such as the business judgement rule (see above, para. 26), to show that they have behaved reasonably. Such a rule 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. Many courts are reluctant to second guess a director who has no conflict of interest and who has satisfied the duties of care and loyalty or to make decisions with the benefit of hindsight. 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. It may also be the case that the business judgement rule provides a defence to some, but not all, of the duties specified under the law. In one State, for example, it does not provide a defence to wrongful or insolvent trading provisions.[33]

6. Enforcement of the directors' duties

(a) Who may bring an action

63. A number of laws limit the right to bring an action against a director by reference to the nature of the action, the person with the power to pursue it and the time at which it is brought. The exercise of avoidance powers under recommendation 87 of the Legislative Guide is not included in summary below.

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[31] For example, France: Commercial Code 2000. See P. Omar, The European initiative on wrongful trading, *Insolv. L.* 2003, 239 at 246.

[32] For example, the Netherlands, id. at 247-248.

[33] For example, Australia, note 29.

64. Under a number of laws, where 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, for example, 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 and officers for contributions to the insolvency estate where their behaviour has contributed to the commencement of insolvency proceedings or constitutes an act of mismanagement.

65. Where the company is near insolvency, that right might be exercised by the company itself and, in some cases by creditors, although the law of many jurisdictions, with a few exceptions,[34] denies creditors the standing to sue the directors of a company before it has made an application for commencement of proceedings. In some States, the court may have inherent power to pursue such an action. Where creditors can take legal action, it will generally be limited to those who have directly and individually suffered harm as a result of the actions of a director. A difficulty often encountered in bringing such an action is proving the connection between the managerial behaviour and the actual damage creditors have suffered. Typically, shareholders are not able to bring actions against directors for breach of duty, either before or after insolvency. However, under some laws in some circumstances, such as where the insolvency representative takes no action, shareholders may have a derivative right. Other laws take a more liberal approach, permitting a wider range of parties to bring an action against a director for breach of a duty in the vicinity of insolvency.

66. A potential difficulty arising in those cases that permit the insolvency representative to bring an action relates to payment of their costs in the event that the action against the director is unsuccessful. As is often the case with avoidance proceedings, insolvency representatives may be unwilling to expend assets of the insolvency estate to pursue litigation unless there is a very good chance of success.

(b) Extent of liability

(i) Damages and compensation

67. 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, employees and the company itself. They may also be liable for payments that result in a reduction of the insolvent estate. 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. In some cases, the liability may attach to specific directors, while in others, the liability of members of the board may be joint and several.

68. 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, where the amount recovered is for the benefit of the insolvency estate.[35] A slightly different approach may allow recovery

[34] For example, Germany and Japan.

[35] Siegel, note 28 at 10.

from the directors of the difference between available assets and the sum necessary for the company to meet its debts.

69. A constraint on director liability in some jurisdictions is the extent of the power provided for shareholder assemblies to dispose of damages claims. While a number of laws do not give shareholders a right to waive or settle damages claims to the detriment of creditors, some do give shareholders a limited right to do so.

70. Where laws provide for director liability, cases in which directors are found liable are, as noted above, apparently rare. In some States, there are few, if any, examples of directors of large companies being held liable under those provisions, although there are examples with respect to closely held companies.[36] In other States, the likelihood of a director of a large company being held liable greatly exceeds that of a director of a smaller company.[37]

(ii) Disqualification

71. A consequence provided for under a few laws where insolvency proceedings commence is disqualification of a director from being a director or from taking part in the running of a company. Under one law,[38] 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 and failure to keep proper account 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 be avoided under grounds similar to those in recommendation 87 of the Legislative Guide 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 found to be unfit often have displayed a lack of commercial probity, gross negligence or serious incompetence, but it is not necessarily always the case.

72. Disqualification may sit alongside other sanctions and personal liability as described above, or may be brought independently where the overall conduct of the individual as a director merits such a sanction. Enforcement of laws that permit disqualification is uneven.

73. The Expert Group recommended that director's disqualification should be imposed, at the EU level, as a sanction for misleading financial and non-financial statements and other forms of misconduct by directors.[39] Many contributors to the 2006 EU Report[40] opposed the adoption of any new legislation on disqualification on the basis of existing national legislative frameworks, some considering that harmonization might even pose constitutional challenges. Many contributors (both opponents and supporters of the proposal to introduce director disqualification) pointed out, however, that it was very important to develop a system of information

[36] For example, Japan.

[37] For example, Germany.

[38] Company Directors Disqualification Act 1986 (Eng).

[39] See note 3, p. 69.

[40] See note 5, pp. 14-15.

exchange and/or to set up better cooperation between authorities in different Member States for information exchange purposes. It was generally agreed that a director disqualified in one Member State should not be able to act as director in another Member State.

IV. The scope and content of possible guidelines

74. Working Group V might wish to consider the following matters in developing guidelines on the duties and liabilities of directors in the vicinity of insolvency:

(a) Defining the persons by whom the duties are owed;

(b) Identifying the persons to whom the duties are owed;

(c) Defining the time at which they arise in the period before commencement of insolvency proceedings;

(d) Specifying the nature of the duties owed or the types of misconduct to be covered, for example:

(i) Wrongful trading — where a director or officer ought to have known that insolvency was unavoidable and the director or officer has failed to take reasonable steps to minimize losses to creditors;

(ii) Breach of duty — where a director or officer has misapplied or retained money or property of the company or where a misfeasance or breach of duty, fiduciary or otherwise, has caused the misapplication of assets or a loss to the company; and

(iii) Misconduct involving company money or property — where a director or officer causes or allows a preference or a transaction at an undervalue to the detriment of creditors; and

(e) Identifying the remedies available for that behaviour or breach of duty.